84-175

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1984

GEORGE BROOKS SCHREIBER, on behalf of himself and other similarly situated shareholders of GenCorp, Inc.,

Petitioner,

vs.

GENCORP, INC., et al.

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether a corporation's Board of Directors -- all of whom are defendants in derivative and class actions directly charged with management frauds -- enjoy a presumption of good faith in voting to terminate shareholders' Federal claims against themselves when they invoke a state "business judgment" rule.

2. Whether, under Rules 23.1 and 23(e), Federal Rules of Civil Procedure, the Court of Appeals should have set aside as an abuse of discretion a settlement of shareholders' claims approved by the District Court where

a) the settlement surrenders actual and potential liabilities exceeding $100 million without benefit to the corporation but with payment of $500 thousand to plaintiffs' counsel as legal fees;

b) the District Court denied objecting shareholders the right to discover evidence regarding director independence and cross-examine witnesses in an evidentiary hearing; and

c) the Court of Appeals fashioned its own "understand[ings]" outside the terms of the settlement in order to affirm the District Court's exercise of discretion.

PARTIES TO THE PROCEEDINGS BELOW

The parties are as follows.

Petitioners: In addition to Schreiber, John J. and Curtiss R. Pearl may file a petition for certiorari. All three, shareholders in GenCorp., Inc., were appellants below. Schreiber also filed a petition to intervene in the District Court.

Respondents: Individual shareholders who were plaintiffs and parties to the settlement are Alter Milberg; Betty Ann Weintraub, successor in interest to David Cohn, deceased; Harry Lewis; Mitchell Kramer; Arthur L. and Dorothy Monheit; Sheldon Barr; and Eileen Kaufman. Corporations which were defendants and parties to the settlement are GenCorp., Inc., formerly known as The General Tire & Rubber Company; its subsidiaries Aerojet-General Corp., General Tire International Co., and RKO General, Inc., and Price Waterhouse & Co., independent auditors to the foregoing companies. Individuals who were defendants and parties to the settlement are Thomas F. O'Neil, Michael Gerald O'Neil, John O'Neil, David S. Henkel, Tress E. Pittenger, L.D. Henry, D. Bruce

Mansfield, James T. Morley, Dr. William B. Walsh, Lester Garvin and Richard B. Tullis -- all directors or former directors of GenCorp., Inc.; J.H. Miller, John J. Dalton, and W.J. Gurtner -- present or former officers and employees of GenCorp., Inc.; J.W. Foss, G.W. Fincher, and R.C. Eichner -- present or former officers and employees of General Tire International; and J.H. Vollbrecht and J.D. Nichols -- present or former officers and employees of Aerojet-General.

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The petitioner respectfully prays for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding.

OPINIONS AND ORDERS BELOW

The opinion of the Court of Appeals, not yet reported, appears in Appendix A.

The Court's order denying rehearing and amended order denying rehearing and rehearing en banc, also not reported, appear in Appendix B. The orders of the District Court for the Northern District of Ohio denying intervention and approving settlement are also not reported.

JURISDICTION

The opinion of the Sixth Circuit Court of Appeals was entered on January 13, 1984. The order denying rehearing and the amended order denying rehearing and rehearing en banc were entered on March 7 and 8, 1984.

On May 21 and June 4, 1984, Justice O'Connor extended time to petition for certiorari to July 31, 1984.

Jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTORY AND OTHER AUTHORITY

Section 10(b), 13(a), and 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b),78m, and 78n(a) and Rule 23.1, Federal Rules of Civil Procedure are set forth in the Statutory Appendix.

STATEMENT OF THE CASE

This case stems from two orders of the District Court for the Northern District of Ohio, per Chief Judge Battisti, denying intervention and approving settlement. Judge Battisti's orders were affirmed by a divided Court of Appeals for the Sixth Circuit on January 13, 1984, over the dissent of Judge Wellford, who thought that approval of settlement was an abuse of discretion. Appendix A. Subsequently (on March 7 and 8, 1984), the Court of Appeals substantially

modified its opinion. Appendix B.[1/]

A few days earlier (on March 2, 1984), the Court of Appeals issued an order in an unrelated but similar case, Hasan v. CleveTrust Realty Investors, et al., Appendix D, vacating an order by District Judge Aldrich comparable to that of Judge Battisti, which the Court of Appeals had affirmed. Both decisions were written by Judge Jones. His decision in Hasan neither refers to nor distinguishes his prior (entirely con-

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1/ Petitioner Schreiber had requested clarification of two clerical oversights in the text of the January 13 opinion. Motion for Clarification of Opinions, January 25, 1984. The Court's amended order incorrectly credited him with seeking "clarification of the language with respect to the scope of the settlement agreement." Appendix B., p. B3.

trary) opinion in this case.

A. The Complaints

This case reflects the efforts of shareholders to fasten responsibility on the management of The General Tire & Rubber Company (now known as GenCorp, Inc.) for the "staggering variety of corporate misconduct" overseas (in Chile and elsewhere) and in the United States, which produced the loss of at least one major-market television station licensed to a GenCorp subsidiary. RKO General, Inc. v. FCC, 670 F.2d 215, 218 (D.C. Cir. 1981), cert. denied 457 U.S. 1119 (1982). In all, eight lawsuits are involved -- four derivative actions (of which one is also a class action) filed in 1976 in Federal District Courts under Sections 10(b), 13(a), and 14(a) of

the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78m(a), and 78n (a), common law fraud, and breach of fiduciary duty;[2] and four derivative actions filed in 1980 in a Federal District Court and in state courts of New York and Delaware.[3] All of the five

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2/ Lewis v. O'Neil, originally filed in N.D. Ohio, E.Div. (C76-344A), consolidated in N.D. Ohio (C77-374); Kramer v. The General Tire & Rubber Company, originally filed in E.D. Pa. (Civil Action No. 76-1525), consolidated in N.D. Ohio (C77-395); Weintraub, successor in interest to Cohn, deceased v. O'Neil, originally filed in D.N.J. (Civil Action No. 76-1006), consolidated in N.D. Ohio (C77-396); and Milberg v. General Tire and Rubber Co., originally filed in S.D. Ohio (C-1-76-323), consolidated in N.D. Ohio (C77-397).

3/ Monheit v. O'Neil, S.D.N.Y. 80 Civ. 0893; Kaufman v. Garvin, Supreme Court of the State of New York, New York County, Index No. 6725/80; Barr v. O'Neil, Supreme Court of the State of New York, New York County, Index No. 7624/80; and Monheit v. O'Neil, Delaware Court of Chancery, Civil Action No. 6149.

Federal actions assert diversity jurisdiction under 28 U.S.C. § 1332; and three of the five also claim jurisdiction under § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

The 1976 suits were filed after the Securities & Exchange Commission began a civil enforcement action against GenCorp and its chairman, which culminated in the entry of a consent judgment, Final Judgment of Permanent Injunction Against the General Tire & Rubber Company and Michael Gerald O'Neil, No. 76-0799 (D.D.C., May 10, 1976), Appendix C, -- but before the Federal Communications Commission adjudicated any of several pending license challenges against RKO General. The 1976 actions

charged GenCorp, its subsidiaries and auditors, all of its directors, and several employees with wrongdoings which triggered the S.E.C. proceeding and endangered the broadcast licenses (contingent on good "character"), together with an on-going course of deception and concealment vis-a-vis Federal regulatory agencies. In the end, it was an "egregious lack of candor" before Federal regulators which was the precise, judicially sanctioned reason an F.C.C. license was lost. RKO General, Inc. v. FCC, supra, 670 F.2d at 238. The 1980 litigation, which added two new directors as defendants, charged specific misconduct subsequent to 1976 (including the cover-up before the F.C.C. and failure to remedy earlier misconduct revealed to the S.E.C.) as further frauds upon the

corporation. Thus a continuum of related charges -- both prospective and retrospective -- involving cumulative frauds was levied against all of GenCorp's directors for past and future losses suffered by the corporation.[4/]

B. GenCorp's "Business Judgment" Defense

During the time period from late 1975 to July 1976 -- when the record before the Court of Appeals for the District of Columbia established that RKO

4/ The cases came before Chief Judge Battisti in 1977, when three of the suits then pending were consolidated for pretrial purposes in the Northern District of Ohio by the order of the Judicial Panel on Multidistrict Litigation, In re General Tire & Rubber Co. Securities Litigation, 429 F. Supp. 1032 (J.P.M.L., 1977), and the fourth joined the others as a "tag-along". The fifth federal case, Monheit-SDNY, supra, was later transferred to the Northern District of Ohio pursuant to 28 U.S.C. § 1404. On June 25, 1981, parties to all eight suits agreed to be bound by the disposition of their common settlement agreement.

did not "display full candor before the [F.C.C.]" nor "begin to cooperate with the S.E.C.", RKO General, Inc. v. FCC, supra, 670 F.2d at 228, 230 -- GenCorp launched its "Special Review Committee". That Committee, through its Special Report a year later, played at least two roles in the ensuing imbroglio: First, it became the mechanism by which GenCorp could satisfy its adjudicated responsibilities to the S.E.C. to disclose illegal practices to investors.[5/] (The undesired con-

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5/ More than 450 American companies participated in the SEC's "Voluntary Disclosure Program" relating to illegal and questionable payments, on the theory that such information is "material" to investors. Securities & Exchange Commission 1934 Act Release No. 15,570 (1979), at n.5. See SEC v. Dresser Industries, 628 F.2d 1368, 1371-2 (D.C. Cir. 1980) (en banc). See generally, SEC Report on Questionable and Illegal Corporate Payments and Practices, submitted to the Senate Committee on Banking, Housing and Urban Affairs, [Footnote 5/ continued on page 11]

sequence of that role was to disclose a cover-up of those illegal practices, for which the F.C.C. disqualified RKO General as a broadcast licensee, Id. at 230.) It also became the centerpiece of a "business judgment" defense[6/] to shareholder derivative litigation, protecting management from liability to shareholders caused by its misconduct.

Over time, the results of this strategy have succeeded for management

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[Footnote 5/ continued from page 10] 94th Cong., 2d Sess, May 12, 1976. GenCorp was not one of the companies participating in the voluntary program, but rather the defendant in one of the more than 50 civil enforcement actions brought in the mid-1970's alleging violations of Federal securities laws for "questionable and illegal" overseas and domestic payments.

6/ The business judgment rule "bars judicial inquiry into actions of directors taken in good faith and in honest pursuit of the legitimate purposes of the corporation. . ." Galef v. Alexander, 615 F.2d 51, 57 (2d Cir. 1980).

-- though not for the corporation nor its shareholders. While GenCorp's S.E.C. liabilities have faded, the company has lost one broadcast station -- valued in this proceeding in excess of $100 million Appendix A, p. A6. The fifteen remaining broadcast licenses continue in controversy before the F.C.C. [7] and the Courts. [8] On the other hand, despite all liabilities, management has yet to be held

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7/ Hearings in Dockets Nos. 16679 and 16680 were resumed with respect to KHJ-TV, Los Angeles. RKO General, Inc. (KHJ-TV), 94 F.C.C.2d 879, June 8, 1983. RKO General's television license in Memphis and 12 radio broadcast licenses have also been opened to challenges, RKO General, Inc., 94 F.C.C. 2d 890, July 15, 1983, and a total of 164 parties have filed competing applications.

8/ The F.C.C.'s renewal of RKO's license to WOR-TV, New York (relicensed to Secaucus, N.J.) was unsuccessfully challenged in the Court of Appeals for the District of Columbia. Multi-State Communications, Inc. v. F.C.C., ____ F.2d ____ (D.C. Cir. 1984), pet. for reh. denied May 7, 1984.

accountable for its enormously costly misconduct in electing to stonewall Federal regulatory agencies,[9/] even though "all the corporate chiefs" -- individual defendants in this litigation -- were named judicially responsible for that ruinous lack of candor. RKO General, Inc. v. F.C.C., supra, 670 F.2d at 231. Indeed, management's representation expenses in this litigation are being paid by the corporation pursuant to an indemnification agreement, GenCorp Proxy Statement, September 12, 1977, p. 14. The corpora-

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9/ A total of $337,260 was repaid to the corporation by seven officers and employees following publication in 1977 of the Special Report, on account of unlawful domestic political contributions revealed therein. Letter of J.J. Dalton to shareholders, October 27, 1977. Far larger losses due to the subsequent withdrawal of broadcast licenses remain without recompense.

tion will also pay generously to plaintiffs' attorneys to settle this litigation and release all shareholder claims.

Key to this continuing strategy to spare management the true costs of its cumulative misconduct has been the effort -- so far successful -- to fend off scrutiny of the false independence and contrived functions of the Special Review Committee. Neither the plaintiffs (through competent discovery) nor either court below (through legally correct evidentiary standards) has penetrated the transparent ruse which surrounds the Special Review Committee.

From the creation of the Committee onward, its independence has only been alleged by GenCorp, not proven. Originally consisting of two directors, later expanded to five (Mansfield, Henry,

Morley, Walsh, and Henkel) and then reduced to four by Henkel's resignation, Special Report, pp. 31 and 33, the Committee was neither mandated by the S.E.C.[10/] nor approved by it[11/]. Rather, the Com-

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10/ Judge Jones' statement that the consent decree "required General Tire to establish a Special Review Committee of its Board of Directors", Appendix A, p. A2, is negated by the language of GenCorp's Consent and Undertaking, that the Board "has established" a Committee, and of the Final Judgment (consent order), that GenCorp shall comply fully with "its undertakings" [emphasis added] See Appendix C, p. C9 and C6-7. The Committee was nothing other than GenCorp's voluntary act, accepted by the SEC for its own limited purposes. Compare Cantor v. Detroit Edison Co., 428 U.S. 578, 594 (1976).

11/ GenCorp's Brief on Appeal, p.3, so claims. Judge Jones' opinion is less comprehensive: "The S.E.C. approved the director chosen to head the committee, the independent counsel to inform the inquiry and the independent accountant procured to aid in the investigation." Neither statement draws support from the record. The most that can be said on the basis of record evidence is that the Final Judgment obligated GenCorp to "comply with its [own] undertakings". [Footnote 11/ continued on page 16]

mittee was volunteered by GenCorp and picked solely by "a process of elimination."[12/]

So selected and called "independent", the Committee was charged by GenCorp to find "those members ... not ... involved in the transactions and activities alleged in the Commission's Complaint ..." Appendix C (Consent and Undertaking), p. C10. It named its own membership and one other director as

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[Footnote 11/ continued from page 15]

See footnote 10/, supra. The record does indicate that the SEC disapproved of one member (Henkel) -- of whom more infra at f.n. 25, p. 29 -- and he resigned from the Committee for that reason. Deposition of T.F. O'Neil, p. 45.

12/ Though GenCorp "[represented] and [undertook]" that the Commission would "consist ... of five independent members of the Board", Appendix C, p. C9, its chairman indicated that the Committee had been selected solely by "a process of elimination ..." Deposition of Mansfield, p.54.

"not involved" -- in a private letter to GenCorp's chairman (not by the Special Report), letter of Mansfield, July 1, 1977 -- together with the Committee's own lawyers and accountants. Appendix A, p. A3. Thus, it laundered a quorum of directors.

Later, that quorum twice sought legal advice whether to pursue the 1976 and 1980 shareholders' derivative actions. Both times, the quorum's counsel stipulated that it only accepted the conclusions of the Special Report (not the letter of transmittal) "at face value" without any inquiry of its own. Letter of Bricker, Evatt, Barton, & Eckler, October 24, 1977, p.1; letter of Bricker & Eckler, March 25, 1980, p.4. On that basis alone, counsel found the quorum "unassociated" with past wrongdoing and hence able to invoke the busi-

ness judgement rule. Thus GenCorp sought to create the illusion of its directors' independence, central to its eligibility to invoke a business judgment defense, by procedures best described colloquially as "doing it with mirrors."[13/] When the quorum then rendered its business judgment, its "independence" was never more than a its own pretense.

C. Proceedings in the District Court

Plaintiffs' complicity in sheltering this maneuver from competent scrutiny

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13/ In sum, GenCorp called its Special Review Committee "independent", because they were not executives. The Committee investigated past wrongdoing and said its own members were not involved, along with one other director -- enough to constitute a quorum -- but not in a public document subject to securities law sanctions. Eminent counsel examined the Committee's public report and proclaimed the quorum "unassociated" with past wrongdoing. The quorum voted to dismiss actions for on-going wrongdoing and losses against all defendants, itself included.

was crucial to its success. To that end, when the quorum of the Board of Directors voted on October 27, 1977 to seek dismissal of the initial 1976 shareholders' litigation and when motions for summary judgment followed, plaintiffs openly abstained from all discovery into the qualifications of GenCorp's Board to raise such a business judgment defense. On January 18, 1979, plaintiffs asked Judge Battisti "for an order permitting plaintiffs to suspend their obligation to complete discovery ... until after the Court has ruled on the Motions for Summary Judgment ..." They ascribed as reason therefor "the enormous expenditure of funds and time ... to complete discovery in a matter of the magnitude raised by the within actions ..." Plaintiffs' Motion to Stay Discovery, January 18, 1979. Thus, rather than seeking to

blunt GenCorp's business judgment defense by inquiring into its valid exercise, plaintiffs asked the court to rule first on the defense before requiring any inquiry into its validity. The Court granted plaintiffs' Motion by its Order of February 7, 1979.

After two years of inactivity (during which the F.C.C. refused renewal of three RKO General television licenses [14]), the District Court sua sponte acted to confirm the obscurity that had been crafted about the mechanisms of GenCorp's business judgment claim. Judge Battisti ordered a modification of his earlier embargo on discovery strictly limited to meet his needs[15] for further

14/ RKO General, Inc. (WNAC-TV), 78 F.C.C. 2d 1 (1980); RKO General, Inc. (KHJ-TV), 78 F.C.C. 2d 355 (1980); and RKO General, Inc. (WOR-TV), 78 F.C.C. 2d 357 (1980).

15/ Citing a need to rule on pending
[Footnote 15/ on page 21]

information

> "concerning the alleged lack of independence of the directors named in this suit. In particular, the Court requires further briefing and such discovery as may be necessary, limited to the use of interrogatories and depositions, on the alleged dominance of the O'Neil family." Order of March 3, 1981, p.2.

This modification defined an extremely narrow path for the limited discovery that would ensue -- confined to the "alleged dominance of the O'Neil

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[Footnote 15/ from page 20]

motions for summary judgment (and oral argument in connection therewith), Judge Battisti also indicated he would subsequently rule on pending motions of plaintiff Milberg for class certification (filed December 19, 1979) and of GenCorp to stay class certification (filed Jan. 17, 1980). GenCorp had therein represented that its business judgment defense against the derivative claims "is potentially dispositive of all issues in these consolidated actions and may obviate the need" to consider class certification. See p.62 infra.

family."[16/] In light of the far wider ambit of circumstances relevant to the independence and good faith of "directors named in this suit" who invoked the business judgment defense, the District Court kept the door closed to much more significant inquiry than it authorized.

With respect to the directors who constituted the quorum voting for a business judgment dismissal, it was less material to their qualifications to illuminate their relationship to GenCorp's controlling family than to identify to what extent they were involved in the cover-up which triggered the loss of a

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16/ In limiting discovery to interrogatories and depositions, the District Court also excluded document discovery and provided an evidentiary basis other than live witnesses subject to cross-examination, that would additionally confine the record compiled for the settlement hearing in this case. See pp. 25-8, infra.

broadcast license, for which all the directors are directly charged as defendants in this litigation.[17/] This inqiury is essential to determining both the availability of a business judgment defense[18/] and the propriety of its exer-

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17/ Judge Jones' opinion in this case is mistaken in stating, "In the instant case, however, the board members are not charged in the derivative actions with direct liability." Appendix A, p. A14. Compare pp. 7-9, supra.

18/ "The business judgment rule as a bar to a shareholder's derivative action is inextricably linked to the requirement... that the plaintiff-shareholder first make a demand on the directors to pursue the claim. See, e.g. Fed. R. Civ. P. 23.1..." Cramer v. General Telephone & Electronics Corp., 582 F.2d 259, 274-5 (3rd Cir., 1978). Rule 23.1 provides the plaintiff must specify "the reasons for his failure to obtain the action or for not making the effort." Note in consequence that the business judgment rule "generally has been held not to apply if a majority of the board is implicated in the alleged wrong." Dent, "The Power of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?", 75 Northwestern U.L.R. 96, 97 and cases cited (1980) [emphasis added].

cise. Such inquiry has never been held in this case.

D. The Settlement in the District Court

Shortly after limited discovery was authorized, the parties reached agreement on a Stipulation of Settlement dated June 25, 1981, which was sent to shareholders on July 20 in anticipation of an August 18 settlement hearing. The essence of the settlement is that plaintiffs release all shareholders' claims against defendants[20/] in exchange for Gen-

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20/ The Stipulation of Settlement leaves no doubt, notwithstanding the subsequent "understand[ings]" of the Court of Appeals, see pp. 61-64 infra, that the parties agreed upon a general release of claims --

> "all claims which are alleged in the complaints or which could have been alleged by reason of, or in connection with or which arise out of, the matters of

[Footnote 20/ continued on page 25]

Corp's payment to plaintiffs' attorneys of $500 thousand in legal fees, plus expenses.[21] Plaintiffs also joined in stipulating that discovery had been "substantially completed" and that GenCorp's Board was "sufficiently independent" to invoke the business judgment rule. Stipulation of Settlement, p. 4-6.

At the settlement hearing, counsel for plaintiffs and defendants appeared in

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[Footnote 20/ continued from page 24]

transactions set forth or referred to in the complaints", Stipulation of Settlement, p.6,

-- Milberg's class claim included. The Notice of Hearing and Proposed Settlement sent to shareholders on July 20 specifically referred to a class claim as being within its scope.

21/ While the settlement agreement recites certain additional "corporate therapeutics" attributed by the parties to the shareholders' litigation, neither the District Court nor the Court of Appeals considered any of these to be material benefits to GenCorp.

support of the settlement, and counsel for objectors Schreiber and the Pearls appeared in opposition. Schreiber also filed a motion to intervene under Rule 24, F.R.C.P., asserting that plaintiffs -- by surrendering all claims without completing relevant discovery -- were not adequately representing his interest as a shareholder. Proponents of the settlement offered no testimony, only counsel's conclusory arguments.[22/] Counsel for ob-

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22/ Counsel for GenCorp's strongest argument for settlement was merely rhetorical:

> "The [Special Report] speaks for itself. How could anyone say that directors who published this report which documents questionable and perhaps shameful conduct over a period of years by company employees, how could anyone say that those directors were dominated and controlled by the company's management?" Tr. p.22.

Counsel for GenCorp also questioned the
[Footnote 22/ continued on page 27]

jector Schreiber submitted certified excerpts from the records of the F.C.C. showing one director (Garvin) to have been centrally involved in the inception in Chile of the fateful GenCorp cover-up.[23/] Counsel for Schreiber also argued that the record was not adequate to

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[Footnote 22 continued from page 26]

bona fides of one objector on grounds that one of his counsel had previously represented potential challengers to RKO General's broadcast licenses. Following refutation at the hearing, Judge Battisti declined to pursue the allegation, Settlement Order, p.14, and the Court of Appeals ignored it.

23/ Director Garvin, who joined the Board in 1978, had previously "served in a key trouble-shooting role for General Tire in Chile..." in 1974 and 1975 when GenCorp was drawing up its battle plan vis-a-vis the SEC, the FCC, license challengers, and shareholders, Tr. p. 37, citing Objection to Proposed Settlement, filed August 7, 1981, p. 13 and Exhibit C thereto. Garvin served on a two-director "Special Litigation Committee" which invoked the business judgement defense anew after the 1980 suits were filed.

approve the settlement and asked for the opportunity to discover evidence and cross-examine witnesses with respect to Garvin, Henkel, and other directors.[24/] Upon learning at the hearing that two key depositions had been placed in the clerk's files at the close of business the day before -- but not produced at the hearing -- objector Schreiber renewed the request for material discovery and also (in a later filing) elucidated admissions from the subject depositions as grounds to reject rather than affirm the settlement.[25/]

24/ Counsel for Schreiber also argued that the Special Review Committee's workpapers (including interview reports said in the Special Report to have disclosed 518 instances of unlawful conduct) should be produced to the Court for in camera inspection to validate the Committee's findings and conclusions. Tr. pp. 42-49. Counsel for objectors the Pearls concurred. Tr. pp. 73-4.

[Footnote 25/ on page 29]

On December 4, 1981, the Court of Appeals for the District of Columbia affirmed the F.C.C.'s earlier denial of the Boston television license, RKO General, Inc. v. F.C.C., supra -- "an estimated loss of over $100,000,000.00" whose effect on GenCorp the District Court "did not consider" "in concluding" eleven days later "that the settlement agreement was 'fair, reasonable, and adequate.'" Appendix A., pp. A6-A7. Notwithstanding this undeniable catastrophe, the District Court approved settlement on December 15,

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[Footnote 25/ from page 28]

25/ Among other things, the depositions established that director Henkel, a partner in GenCorp's law firm Sullivan & Cromwell, was disqualified as an independent director by a clear conflict-of-interest, in that he was the architect of GenCorp's multifaceted defense. Response of Objector Schreiber, September 10, 1981, p. 3, citing deposition of T.F. O'Neil, p. 28 & 29.

1981. The Settlement Order was premised on the findings that "the directors very likely had power to dismiss the derivative suits under the business judgment rule", Settlement Order, p.1, and that defendants, consequently, "had a strong likelihood for success on the merits of their motion for summary judgment." Id., p.5.

Judge Battisti's forecast rested, in turn, on an express evidentiary premise:

> "Directors of a corporation are presumed to act in good faith, Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903). The good faith of these directors has not been seriously challenged. [footnote omitted] Objectors are therefore thrown back upon the argument that these individuals were in some way disabled, by bias or personal consideration, from rendering disinterested judgment when they decided to dismiss the suits ... [citation omitted]." Id., pp. 7-8.

The Court found no "suspicious relationships between [the] outside directors

and the inside management of General Tire" and "little, if any, evidence to temper their appearance of being upright, responsible leaders in the business and civic communities."[26/] Id., p.8. The District Court also declined to delay settlement pending the outcome of on-going license and tax reviews (which might further enlarge GenCorp's already large, though unacknowledged losses), finding that the Court "cannot permit such a sword of Damocles to be suspended above" management that would constitute "a longterm, destructive impediment" to the firm. Id., p.13.

26/ Director Henkel merely "provided legal assistance to the Company as outside counsel for Securities-related matters for many years" and Garvin (echoing GenCorp's words) was just an "independent consultant" whose "role in Chile in 1974-1975 consisted of investigating improprieties which had already taken place." Id., pp. 8-9.

The District Court did not mention the pending class action in Milberg. Nor did it return to resolve "the need for further discovery", which -- in an earlier order, dated December 8, 1981, denying Schreiber's petition to intervene -- it had promised to resolve.

E. Proceedings in the Court of Appeals

The opinion of the Court of Appeals for the Sixth Circuit, per Judge Jones joined by District Judge Harvey (E.D. Mich.), Appendix A, affirmed the approval of the settlement without attempting to differentiate between the appearance of director independence and the record of bare assertion,[27/] previously disclosed

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27/ For example, Judge Jones recited (Appendix A, p. A3) that "a Committee" of Directors retained an "independent law firm", which in turn found that "Henkel,

[Footnote 27/ continued on page 33]

here at pp. 14-18, supra. After summarizing the uncertainties attending the Ohio business judgment rule,[28] the majority concluded that the District Court

[Footnote 27/ continued from page 32] Henry, Mansfield, Marley (sic] and Walsh were ... 'independent members' of the Board" -- heedless of the factual circularity of that reference and the "independent" law firm's frank disclaimers that it did anything other than take the Committee's findings "at face value." Supra, p. 17.

28/ The majority said, "Although we do not find the impact of the Ohio business judgment rule upon this case to be 'crystal clear,' we do agree with the district court's assessment of that impact." Appendix A, p. A8. See also, p. A22. The Court of Appeals felt that the District Court's analysis had, in any event, satisfied the "more severe" of two possible formulations and should not be disturbed. Appendix A, p. A13. The appellate court went on to find,

> The objectors [sic] clearly complied with Rule 23.1's 'demand' requirement and thus the district court found no procedural defect in initiating the derivative suit. Id.

In that case, bias having presumably been shown to dispense with a demand on directors, Judge Jones did not specify how the directors then had the power to achieve a business judgment dismissal. See supra, f.n. 18, p. 23.

"did indeed carefully consider the disinterestedness of the outside directors." Appendix A, p. A14. The majority's review and endorsement of the treatment given this central issue by the District Court leave no doubt that the Court of Appeals approved the District Court's application of a presumption of director independence[29/]. Appendix A, p. A14-A16.

29/ The majority posed the issue of director independence as follows:

> "Generally, assertions of the director's lack of good faith [emphasis added] must be supported by facts rather than by invective and conclusory allegations .... In circumstances in which the directors are directly liable [emphasis in the original], however, a well-pleaded complaint may suffice to place the burden on the director to prove inde pendence. ... In the instant case, however, the board members are not charged in the derivative actions with direct

[Footnote 29/ continued on page 35]

In a long footnote, Appendix A, p. A16, f.n. 6, the majority concluded that the District Court had "certainly allowed the objectors 'meaningful participation' in the settlement hearing generally and on the question of director disinterest particularly". The consequent denial of their discovery rights was justified because of the presence of a "plethora of information submitted to the district court" and the sufficiency of "post-hearing papers to incorporate any information revealed" by depositions filed the day before the hearing. Id.

[Footnote 29/ cont'd from page 34]

liability. "[emphasis added]" Appendix A., p. A14.

The majority's assumption that the directors were not charged with "direct" responsibility for misconduct in losing the broadcast station is a patent error that goes to the heart of this litigation.

The majority accepted the District Court's finding that the settlement was fair, reasonable, and adequate and well within its wide discretion. In essence,

> While the monetary losses surrounding the FCC and IRS proceedings may be unfortunate, they counteract neither the independence of the Committee's business judgment, nor the independence of the district court's additional business judgment. Appendix A, p. A20.

Judge Wellford dissented with respect to the fairness of the settlement, noting that the District Court had not considered the reality and the magnitude of GenCorp's $100 million loss. Appendix A, p. A23. He also believed that the District Court "did not take fully into account" GenCorp's cover-up -- raising the prospect of still greater future losses -- for which "defendant directors may have had some responsibility." Id.

He said that the unique benefits of the settlement were "negligible", the risks of litigation were substantial, and the payment of $500 thousand in lawyers' fees "renders the fairness of such settlement even more dubious. Id.

In particular, Judge Wellford viewed the comprehensive sweep of the settlement -- releasing defendants and barring all potential liabilities for loss of multiple broadcast licenses and tax claims as well as class claims[30/] -- as an abuse of discretion. Appendix A, p. A24.

30/ "Whether or not the settlement terminated the present and any future class action challenges, including the Milberg action it seems clear that the district court intended its order to do just that ..." Id. Judge Wellford thus departed from Judge Jones' dictum in the majority opinion, "We do not understand this settlement, however, to encompass the denial of any such class action." Appendix A, p. A18, f.n. 7.

After Schreiber and the Pearls filed timely Petitions for Rehearing En Banc, the panel issued orders on rehearing which appear in Appendix B. In its first order, dated March 7, the Court ignored the fact that both petitions were addressed to the full court, denied the Pearls' petition, dismissed Schreiber's petition as "not timely filed", and rendered sua sponte a "clarification" of its January 13 opinion. The "clarification" enlarged the majority's previous "understand[ing]" of the scope of the release of claims provided in the settlement agreement, see supra, f.n. 30/, to perpetuate future liabilities for "the very serious additional F.C.C. and I.R.S. proceedings against General Tire." The Court's amended order, dated March 8, (vacating the prior order) re-

cited that the two petitions had been treated as petitions for rehearing en banc, so circulated, and returned to the panel inasmuch as no active judge requested a polling. The "clarification" previously adopted was retained, now stipulated to be issued in response to Schreiber's pending motion for clarification, but see supra, f.n. 1/, p. 4, which was in all other respects denied.

While the foregoing petitions for rehearing en banc were still pending, a different panel of the Court of Appeals, also per Judge Jones, decided the case Hasan v. CleveTrust Realty Investors, Inc., the opinion in which appears in Appendix D hereto. There, the Court vacated a holding by Judge Aldrich of the District Court for the Northern District of Ohio in which she had granted summary

judgment in a shareholders' derivative suit after measuring the qualifications of a special litigation committee in accordance with "a presumption of good faith, subject to concrete evidence to the contrary." Hasan v. CleveTrust Realty Investors, Inc., 548 F. Supp. 1146, 1149 (N.D. Ohio, 1982), vacated -- F.2d -- (6th Cir., March 2, 1984), reh. denied May 8, 1984. Judge Jones wrote:

> Far from supporting a presumption of good faith, the pressures placed upon such a committee may be so great as to justify a presumption against independence ... In the case before us, however, we need not determine the propriety of a conclusive presumption against good faith. We do conclude, though, that the policies of the business judgment rule do not create a presumption in favor of the good faith of a special committee and that the realities of corporate life militate against any such presumption." Appendix D, pp. D9-D10.

Judge Jones went on to hold that the presence in the directors' committee of

> "personal interests" and "prior affiliation with the corporation" preclude any affirmative demonstration of disinterest. We find therefore that the corporation has not met its burden of demonstrating the good faith and disinterestedness of [the committee]." Appendix D., p. D14.

Schreiber's subsequent Motion for Leave to File a Renewed Petition for Rehearing En Banc in this case -- filed on March 14, 1984 and occasioned by the contrary, unexplained, near-simultaneous opinion on the same question by the same judge in another case -- was denied by the panel of the Court on May 2, 1984.

This petition for a writ of certiorari followed.

REASONS FOR GRANTING THE WRIT

I.

THE COURT OF APPEALS' APPROVAL OF A BUSINESS JUDGMENT DISMISSAL BASED ON A PRESUMPTION OF GOOD FAITH FOR DIRECTORS CHARGED WITH WRONGDOING CONFLICTS WITH AT LEAST ONE OTHER CIRCUIT AND EXCEEDS THE LIMITED SCOPE FOR STATE LAW DISMISSALS PERMITTED BY BURKS V. LASKER.

By fundamentally mischaracterizing the issues in this litigation [31], the

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31/ Contrast the majority holding --

> In circumstances in which the directors are directly liable ... a well-pleaded complaint may suffice to place the burden upon the director to prove independence ... In the instant case, however, the board members are not charged in the derivative actions with direct liability." Appendix A., p. A14 --

with Judge Wellford's dissent --

> The consideration of the reasonableness of the settlement did not take fully into account alleged "cover-up" activities after 1975 with respect to administrative investigations and the effect of

[Footnote 31/ continued on page 43]

majority of the Court of Appeals miscast the relevant burden of proof away from the directors rather than upon them, where it properly belonged.[32/] In consequence, the Court affirmed the settlement

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[Footnote 31/ cont'd from page 42]

> additional IRS actions pending against defendant General Tire and RKO General due to irregularities, and shareholders were not alerted to this additional potential loss, for which defendant directors may have had some responsibility." Appendix A., p. A23.

32/ Contrast the majority's holding, "Generally, assertions of the director's lack of good faith must be supported by facts rather than by invective and conclusory allegations.", Appendix A, p. A 14, with "[t]he corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.", Zapata Corporation v. Maldonado, 430 A.2d 779, 781 (Del. Sup. Ct., 1981). See also Hasan v. CleveTrust Realty Investors, Inc., supra, in which the Sixth Circuit concluded that "the policies of the business judgment rule do not create a presumption in favor of the good faith of a special committee..." Appendix D, p. D10.

in part on the ground[33] that "the objector's [sic] had not demonstrated that the directors were biased", Appendix A, p. A14, and that there was insufficient evidence of the outside director's [sic] fraud or bad faith to warrant the conclusion of the lack of independence." Id. p. A16.

At the same time, the majority also recited that,

> the objectors [sic] clearly complied with Rule 23.1 [F.R.C.P.]'s "demand" and thus the district court found no procedural defect in initiating the derivative suit." Appendix A., p. A13.

In other words, the complaints had adequately alleged bias, excusing demand on the directors. Hence, the majority's

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33/ The majority's second ground for affirmance --"the district court's additional business judgment" Appendix A, p. A20 -- gives rise to Reason II for the writ, infra, pp. 55-64.

holding rested on a tour de force: It applied an evidentiary standard it said was not applicable where bias was charged -- a presumption of good faith, see f.n. 31, supra -- to circumstances where, it said, bias was "clearly" charged!

The foregoing anomaly is not spurious, but the direct result of a bizarre and incomplete evidentiary record. The record was truncated by the consensus reached between the plaintiffs and defendants to settle these cases without litigating the motions for summary judgment, which had raised the business judgment defense, and after only minimal discovery. Under Rules 23.1 and 23(e), F.R.C.P., the question before the District Court thus became far less demanding -- whether the settlement is "fair, reasonable, and adequate and is not the product of collusion

between the parties." Cotton v. Hinton, 559 F.2d 1326, 1330 (5th Cir. 1977). A misplaced presumption of good faith for directors' actions[34/] then became a shield against objectors' claims that the directors lacked independence and that truly adversary discovery was required.

The business judgment rule embodied in the corporation laws of many states has a limited sphere of application. As framed by Justice Brandeis,

> Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions ordinarily a matter of internal management, and is left to the

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34/ The District Court's only authority for applying that presumption was dictum in Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455, 463 (1903):

> The directors represent all of the stockholders, and are presumed to act honestly and according to their best judgment for the interests of all.

> discretion of the directors, in the absence of instruction by vote of the stockholders. Courts interfere seldom to control such discretion intra vires the corporation, except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment ..." United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-4 (1917).

Thus judicial interference is permissible when directors "stand in a dual relation which prevents an unprejudiced exercise of judgment."

The green light for shareholder litigation is especially clear when the directors invoking a business judgment defense are themselves defendants specifically charged with wrongdoing, according to two Second Circuit cases with which this holding by the Sixth Circuit is in sharp conflict. In Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980) -- like this

case concerned with the law of Ohio --

the Second Circuit held:

> We are not aware of any case that has determined that directors against whom a claim has been asserted and who have determined that the claim against them should not be pursued, do not "stand in a dual relation which prevents an unprejudiced exercise of judgment." Indeed, the Eighth Circuit has opined, obiter, that "where the directors, themselves, are subject to personal liability in the action [they] cannot be expected to determine impartially whether it is warranted." Abbey v. Control Data Corp., 603 F.2d 724, 727 (8th Cir. 1979) (emphasis added), cert. denied, ___ U.S. ___, 100 S.Ct. 670, 62 L.Ed. 647 (1980), and one district court has termed it
>
> > inconceivable that directors who participated in and allegedly approved of the transaction under attack can be said to have exercised unbiased business judgment in declining suit based on that very transaction.
>
> Nussbacher v. Chase Manhattan Bank, 444 F. Supp. 973, 977 (S.D.N.Y. 1977). Galef v.

Alexander, supra, 615 F.2d at 60-1.

[Emphasis in the original]

Also, in Joy v. North, 692 F.2d 880, 888 (2d Cir., 1982), cert. denied 103 S. Ct. 1498 sub nom Citytrust v. Joy (1983), the Second Circuit ruled in terms no less applicable here for defendant directors who named themselves to a special committee which then laundered their own independence --

> The conflict of interest which renders the business judgment rule inapplicable in the case of directors who are defendants is hardly eliminated by the creation of a special litigation committee. 35/

35/ Joy provides further guidance as to how the District Court and the Sixth Circuit should have responded to Schreiber's reasonable request for in camera production of the Special Review Committee's secret workpapers. The Second Circuit rebuked the district court for allowing committees "routinely ... to do their work in the dark of night" and stipulated that the committee must "disclose to the court and the parties not only its report but all underlying data." Id. at p. 893.

Yet in this case, whose flagrancy portends future emulation, the Sixth Circuit ruled that it was not an abuse of discretion for the District Court to find distinterestedness in Henkel[36/], GenCorp's "outside counsel for Securities-related matters for many years", and in Garvin, GenCorp's trouble-shooter in Chile, who "only participated in [the]... attempt to scrutinize the corporation's affairs after they had occurred" -- and before they were belatedly disclosed to the S.E.C. and the F.C.C. Appendix A, p. A15. By contrast, in Hasan, supra,

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36/ During the precise time period embracing the functioning of the Special Review Committee and the invocation of the business judgment defense by GenCorp's directors (January 30, 1975 to November 30, 1977), Mr. Henkel's law firm was paid slightly over $1 million in legal fees by GenCorp. The American Lawyer, Outside Counsel: Inside Director (1979 Rev. Ed.), p. 297.

where plaintiffs similarly "declined to pursue discovery" on the question of director involvement, Galvin's "personal interests" and "prior affiliation with the corporation" were sufficient to "preclude any affirmative demonstration of disinterest" and keep the corporation from meeting "its burden of demonstrating the good faith and disinterestedness" of the committee. Appendix D, pp. D13 and D14.

Thus, a key conflict has arisen in the evidentiary standards applied to a common factual situation -- not only between the Sixth Circuit and at least one other Circuit, but even within the Sixth Circuit itself in two opinions by a single judge. The holding in this case applying a presumption of good faith and allocating the burden of proof to the objectors also

conflicts with both of the emerging "polar approaches" to business judgment review followed by state courts, Appendix D, p. D12, each of which places the burden of showing good faith upon the corporation. Zapata Corp. v. Maldonado, 438 A.2d at 788. Auerbach v. Bennett, 393 N.E.2d 994, 1002-3, 419 N.Y.S.2d 920, 929 (N.Y. App. 1979). Moreover, as a practical matter, relieving defendants of their burdens of proof as to independence and good faith, in the context of this case, will create contorted and anomalous precedent both for defendants who move for summary judgment under Rule 56, F.R.C.P., and must therefore demonstrate that there is "no genuine issue as to any material fact," Adickes v. S.H. Kress & Co., 398 U.S. 144, 157 (1970), and for proponents of settlement who have

the burden to demonstrate fairness. Maher v. Zapata Corp., 714 F.2d 436, 454 (5th Cir. 1983). See also Dent, supra, 75 Northwestern U. L. R. at 134.

Finally, by propounding a presumption of good faith for business judgment terminations, this case has raised fundamental and highly troublesome questions as to the future role for federally authorized derivative claims arising under the Securities Exchange Act of 1934 in the face of the rampant application of state-created termination powers. Though in Burks v. Lasker, 441 U.S. 471 (1979) this Court mandated judicial efforts to harmonize state corporation rules with the policies underlying particular federally-created shareholders' rights of action,[37/] the Sixth Circuit in

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37/ In Lasker v. Burks, 426 F. Supp.
[Footnote 37/ on page 54]

this case has rendered any federal claim subject to a premature death if and to the extent that defendants succeed in controlling the evidentiary record. The inducements hereafter to strike suits and collusive settlements will be enhanced.

Burks' concern that "'specific aberrant or hostile state rules'" not be permitted to destroy "'any identifiable federal policy or interest...'", 441 U.S. at 479, justifies that this case be reviewed to resolve the important

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[Footnote 37/from page 53]

844, 852 (S.D.N.Y. 1977), reversed 567 F.2d 1208 (2d Cir. 1978), reversed 441 U.S. 471 (1979), Judge Werker had said it was "incumbent upon plaintiffs to establish that the minority directors actions lacked independence." In consequence of the double reversal his holding subsequently received, the standard acceptable to this Court on this key evidentiary issue remains unclear.

questions of federal law which its doubtful evidentiary standard has created.

II

UNDER ITS SUPERVISORY POWERS, THE SUPREME COURT SHOULD REVIEW AND SET ASIDE THE SIXTH CIRCUIT'S ACCEPTANCE OF THIS IMPROPER AND PROCEDURALLY INFIRM SETTLEMENT.

"The denial of a license renewal to a major licensee in a major market is of manifest moment and financial impact." RKO General, Inc. v. F.C.C., supra, 670 F.2d at 238. So the Court of Appeals for the District of Columbia Circuit termed the significance of its affirming the F.C.C.'s action. A year and a half later, when an accounting was due to GenCorp's shareholders for that confirmed $100 million loss, Judge Battisti's reaction was to ignore it. "The district court did not consider the effect of that specific dollar loss in concluding that the settlement

agreement was 'fair, reasonable and adequate.'" Appendix A, pp. A6-A7. But Judge Wellford rightly termed the District Court's action an "abuse of discretion", Appendix A, p. A24, which, due to the magnitude of the loss and the procedural infirmities in both courts below, this Court should now set aside.

A. Release of All Management Liabilities in Exchange for Substantial Plaintiffs' Lawyers' Fees Was an Abuse of Discretion.

Its impropriety compounded by the "incestuous" bias evident in GenCorp's directors trying to dismiss claims against themselves, see Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49, 54 (5th Cir. 1980), cert. denied 450 U.S. 1029 (1981), the settlement negotiated in this case could not, by reason of its terms, be considered "fair, reasonable, or adequate." Judge Wellford's charac-

terizations of the benefits to the corporation as "negligible" and "miniscule", the liabilities facing defendants as "very serious", their difficulties in continuing litigation as "considerable", and the propriety of plaintiffs' lawyers' fees as "dubious", Appendix A, pp. A22-A23, comprise a far more negative calculus under City of Detroit v. Grinnell Corp., 495 F.2d 448, 463 (2d Cir. 1974), than that drawn by Judge Battisti.

Extinguishing class claims without due procedural safeguards, Magana v. Platzer Shipyard, Inc., 74 F.R.D. 61 (S.D. Tex. 1977), and bartering all shareholders' rights in exchange for generous lawyers' fees that could not be paid had a trial produced a comparable zero recovery, Jamison v. Butcher & Sherrerd, 68 F.R.D. 479 (E.D. Pa. 1975)

without support in the record are particularly gross violations of the courts' duty to exercise informed discretion. Protective Committee v. Anderson, 390 U.S. 414, 424, 434 (1968). Nor does the record in this case permit the sparse reasoning in the District Court's holding to be glossed over with hyperbole such as "penetrating review" and "astute ... assess[ment]," Appendix A, pp. A20, A21.

This Court should set apologetics to naught and vacate the approval of the settlement.

B. The District Court Denied Objectors "Meaningful Participation" in the Settlement Hearing.

As recognized by the majority below, Appendix A, p. A16, f.n. 6, objectors at the settlement hearing were entitled to "meaningful participation", Girsh v.

Jepson, 521 F.2d 153, 158 (3d Cir. 1975), which they did not receive. The restraints imposed by Judge Battisti effectively denied them these rights.

Under Girsh, objectors' rights specifically include "an adequate opportunity to test by discovery the strengths and weaknesses of the proposed settlement." Id. at 157. In Greenfield v. Villager Industries, Inc., 483 F.2d 824, 832 (3d Cir. 1973) these rights included "cross-examination and argument to the court". Here (as in Girsh, where the practice was condemned) key "testimony" was not made available until as late as 4:06 p.m. the day before the Settlement Hearing. Response of Schreiber to the court's requests with respect to settlement, p. 2; Exhibit A, p. 1; Exhibit B, p. 1. The Sixth Circuit's suggestion

that objectors were, nonetheless, accorded "meaningful participation" by being allowed to file "post-hearing papers", Appendix A, p. A16, f.n. 6, cannot equate to the requisite right to cross-examine witnesses.

Moreover, it matters not that there was a "plethora of information" before the district court, Id., if that information was not dispositive of the question of director independence. The materiality of objectors' need for discovery also weighs heavily in the balance, in this case as in Cohen v. Young, 127 F.2d 721 (6th Cir. 1942). In Cohen, the central issue to the fairness of the settlement was Young's solvency; here the central issue is the independence of the directors -- each being questions that require sensitive

judgment by the district judge and informed judicial review. The rights to incorporate in the record "documents relied on by the attorneys", Id. at 725, and "if desired, to cross-examine thereon either in open court or in camera", Id. at 724, were essential accomodations to objectors that the district judge had wrongly refused, as this Court recognized in Cohen. The same vices infect this case, and now justify the review of the Sixth Circuit's opinion.

C. The Court of Appeals' Efforts on Rehearing to Recast the Settlement Agreement Cannot Remedy its Impropriety.

On rehearing, the panel fashioned a "clarification" of the Settlement Agreement, see supra, p. 3-4, and f.n. 1, which eliminated from the general release negotiated by the parties the bar to

class claims and claims for possible future license and tax losses. The panel's "understand[ings]", Appendix A, p. 18, f.n. 7, Appendix B, pp. B1 and B2, are in conflict with comprehensive language in the plain text of the Settlement Agreement, see f.n. 20, p. 24, supra, and the parties' prior course of conduct, see, e.g., f.n. 15, p. 21. They should not be allowed -- late in the day -- to foreclose review in the guise of curing a possible abuse of discretion.

Factually unsupported, the panel's effort to fortify the settlement only diminishes its coherence. Central to the rationale of the District Court's holding and reiterated in the majority's original opinion was the parties' aim to lift the "sword of Damocles" of continuing litigation from GenCorp's boardroom to permit management to restore the

corporation's fortunes. Appendix A, p. A20. By purporting on rehearing to remove that fundamental logical prop for the directors' and the District Court's business judgments, the Court of Appeals only undermined their essential purposes.

Finally, in attempting to modify the terms of the settlement negotiated between the parties, the Court of Appeals was arbitrary, in sum indulging its own "business judgment" beyond its judicial powers. "Judges should not substitute their own judgment as to optimal settlement terms for the judgment of the litigants and their counsel." Armstrong v. Board of School Directors of the City of Milwaukee, 616 F.2d 305, 315 (7th Cir. 1980). "The Court can reject a settlement that is inadequate; it cannot undertake the partisan task of bargaining for

better terms..." In Re General Motors Corp. Engine Interchange Litigation, 594 F.2d 1106, 1125, f.n. 24 (7th Cir.), cert. denied, 444 U.S. 870 (1979), quoting Haudek, "The Settlement and Approval of Shareholders' Actions -- Part II: The Settlement," 23 Southwestern L.J. 765, 771-2 (1969).

The Supreme Court should, therefore, set aside these opinions of the Sixth Circuit, which have departed so far from the accepted and usual course of judicial proceedings.

CONCLUSION

For the reasons set forth above, petitioner respectfully submits that the decisions below of the Sixth Circuit conflict with holdings of this Court, other circuits, and the Sixth Circuit itself, and should be reviewed. Moreover, the

settlement approved by the District Court and affirmed by the Sixth Circuit is an abuse of discretion that is likely to undermine seriously the beneficial purposes of shareholders' litigation. This Court should therefore issue its writ of certiorari to set these erroneous holdings aside.

July 31, 1984 Respectfully submitted,

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STATUTORY APPENDIX

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange --
>
> > (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules or regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 13(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m, provides:

> (a) Every issuer of a security registered pursuant to section 781 of this title shall file with the Commission, in accordance

with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security =

(1) such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 781 of this title, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

(2) such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by independent public accountants, and such quarterly reports (and such copies thereof), as the Commission may prescribe.

Every issuer of a security registered on a national securities exchange shall also file a duplicate original of such information, documents, and reports with the exchange.

Section 14(a) of the Securities

Exchange Act of 1934, 15 U.S.C. § 78n (a), provides

> (a) It shall be unlawful for any person, by the use of the mailsr by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

Rule 23.1, Federal Rules of Civil Procedure provides:

> In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by

operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

RECOMMENDED FOR FULL TEXT PUBLICATION
See, Sixth Circuit Rule 24

Nos. 82-3129/3130

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

IN RE: GENERAL TIRE AND RUBBER COMPANY SECURITIES LITIGATION.	
JOHN J. PEARL & CURTIS R. PEARL (82-3129), GEORGE BROOKS SCHREIBER (82-3130), *Objectors-Appellants,* v. THE GENERAL TIRE & RUBBER COMPANY, ET AL *Appellees.*	ON APPEAL from the United States District Court for the Northern District of Ohio.

Decided and Filed January 13, 1984

Before: JONES and WELLFORD, Circuit Judges; and HARVEY, District Judge.*

JONES, Circuit Judge, delivered the opinion of the Court, in which HARVEY, District Judge, joined. WELLFORD, Circuit

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* The Honorable James Harvey, District Judge, U.S. District Court, Bay City, Michigan, sitting by designation.

Judge, (pp. 22-24) filed a separate opinion concurring in part, dissenting in part.

JONES, Circuit Judge. Objecting stockholders of General Tire and Rubber Company (General Tire) John J. Pearl, Curtis R. Pearl and George B. Schreiber (objectors) appeal from an order of the district court approving the settlement of derivative claims arising from General Tire's extensive corporate misfeasance. Schreiber additionally contends that the district court erred in denying his petition to intervene, while the Pearls additionally claim that the district court erred in failing to provide adequate notice of and an adequate hearing on the proposed settlement. The principal issue before this Court, however, is whether the district court's approval of the settlement of eight shareholder derivative suits pending against General Tire constituted an abuse of discretion. After careful consideration of the law and policy in this complex area, we conclude that the district court did not abuse its discretion in approving the settlement.

The lengthy and convoluted history, from which the present appeal derives, begins in the 1960's and early 1970's. During that period, General Tire engaged in ubiquitous corporate improprieties and apparent illegalities. The United States Securities and Exchange Commission (SEC) uncovered these activities and instituted civil proceedings against General Tire. On May 10, 1976, the SEC's investigation culminated in the filing of a complaint, consent decree and judgment. *SEC* v. *The General Tire and Rubber Co.*, [1975-76] Fed. Sec. L. Rep. (CCN) ¶ 95, 542 (D.D.C. 1976).

This consent decree permanently enjoined General Tire from committing similar violations in the future. The decree also required General Tire to establish a Special Review Committee of its Board of Directors for the purpose of investigating and reporting the suspect activities cited in the SEC's complaint. The SEC approved the director chosen to head the committee, the independent counsel selected to inform the inquiry and the independent accountant procured to aid in the investigation. The committee conducted an extensive in-

vestigation, and filed a thorough report in the United States District Court for the District of Columbia. The report details General Tire's prior offensive and illegal practices, and suggests remedial action to prevent future improprieties. The Committee recommended that General Tire overhaul internal auditing procedures, enlarge the scope of independent accountant review, revise the procedures of General Tire's wholly-owned subsidiary, RKO General, and return misappropriated corporate funds. The Committee also determined that because board members Henkel, Henry, Mansfield, Morely, O'Neil and Walsh were not involved in any of the cited suspect activities, they were qualified to implement the proposed changes. In addition, the Committee found that the law and accounting firms chosen to investigate General Tire had no previous contact with the Company.

While the Special Committee conducted its investigation, four separate derivative suits were filed on behalf of General Tire against certain officers and directors alleging damages and seeking remedial relief from the "questionable payments" cited in the SEC complaint.[1] On April 18, 1977, the Judicial Panel on Multi-district Litigation consolidated the suits in the Northern District of Ohio. *In Re: General Tire & Rubber Company Securities Litigation*, 429 F. Supp. 1032 (J.P.M.D.L. 1977). A Committee of the General Tire Board of Directors then retained the independent law firm of Bricker, Evatt, Barton & Eckler of Columbus, Ohio (presently Bricker & Eckler) to aid them in determining whether the continuation of the derivative suits was in General Tire's best interests. The Bricker firm concluded that independent members of the Board had the power to discontinue the suits, that Henkel, Henry, Mansfield, Marley and Walsh were such "independent members" and that they should instruct their counsel to "seek

[1] The derivative actions are cited: *Mitchell A. Kramer* v. *The General Tire and Rubber Co.*, E.D. Pa., Civ. Action No. 76-1525; *Cohn* v. *O'Neil*, D.N.J., Civ. Action No. 76-1006; *Alter Milberg* v. *General Tire*, S.D. Ohio, Civ. Action No. C-1-76-323; *Harry Lewis* v. *O'Neill*, N.D. Ohio, Civ. Action No. C76-344A.

dismissal of the four shareholders derivative suits now pending against the company."[2] Following Bricker's recommendations, these directors decided not to pursue the derivative suits. General Tire and various individual defendants thereafter moved for summary dismissal of the suits. Those motions and further discovery were stayed, pending approval of the settlement.

On January 24, 1980, the Federal Communications Commission (FCC) refused to renew broadcast licenses held by RKO General, a wholly-owned subsidiary of General Tire. These licenses are worth over ten million dollars. The FCC based its decision to deny renewal on the fact that (1) General Tire and RKO General had engaged in reciprocal trade practices in contravention of the anti-trust laws, (2) RKO had filed inaccurate financial records, and (3) RKO had deliberately withheld information from the SEC in its investigation of General Tire. *In Re: Application of RKO General, Inc.*, 78 FCC 2d 1 (1980). RKO appealed the FCC's decision to the United States Court of Appeals for the District of Columbia. The Court reversed the loss of two licenses, but affirmed the loss of a third license because RKO wrongfully withheld information during the renewal proceedings.[3]

After the FCC decided to deny the licenses, derivative suits were filed on behalf of both RKO and General Tire. These suits were calculated to recover damages incurred by General Tire and RKO as a result of the loss of the licenses. On March 27, 1980, two new directors, Lester Garvin and R. B. Tullis, were appointed by General Tire to another special litigation committee. They recommended that the Company invoke the business judgment rule and dismiss the derivative actions. That recommendation was supported by additional conclusions reached by Bricker. Seven "independent" direc-

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[2] Exhibit G to 1977 Dalton Aff't, at 3.

[3] The licenses were KHJ-TV (Los Angeles), WOR-TV (New York) and WNAC-TV (Boston).

tors adopted the recommendation, whereupon the defendants filed motions to dismiss and for summary judgment. The suit was then transferred to the United States District Court for the Northern District of Ohio and joined for settlement purposes with the four previous 1977 derivative suits.[4]

On March 3, 1981, the district court ordered discovery on the issue of the independence of directors and requested supplemental briefing on the effect of the termination of RKO's licenses. The plaintiffs in the derivative suits were persuaded by discovery that the directors were indeed independent. After discovery, the parties entered into settlement negotiations.

On June 25, 1981, the parties in the several derivative actions presented for the district court's approval a Stipulation of Settlement. The terms of that Settlement are the subject of this appeal. Those terms reflect the parties' belief that General Tire's independent directors were empowered, as a matter of law, to determine whether these actions should be maintained, that those directors were duly chosen to dismiss the actions and that the continuation of the litigation would create a great business hardship for General Tire. The settlement also acknowledges the plaintiffs' role in implementing remedial action to prevent future improprieties and provides for the appointment for three years of two "outside" directors on the RKO Board. Although the plaintiffs' attorneys did receive a fee award, neither General Tire nor RKO recovered monetary damages. The settlement's terms finally require the dismissal of all claims relating to the complaints and the waiver of all rights to recover losses incurred by General Tire.

On July 20, 1981, notice of a settlement hearing was sent to all 50,000 of General Tire's shareholders. The notice de-

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[4] The new derivative suites are cited: *Kaufman* v. *Garvin, et al.*, N.Y. Sup. Ct. Index No. 67231/80; *Bar* v. *O'Neil, et al*, N.Y. Sup. Ct. Index No. 67241/80; *Monheit* v. *O'Neil*, No. 81-4141 (N.D. Ohio); *Monheit* v. *O'Neil*, Del. Ch. Civ. No. 6149.

scribed the nature of the case, the terms of the proposed settlement, the independent directors' conclusion that the continuation of the derivative suits was not in the corporation's best interest and the shareholders' right to appear at the hearing and object to the terms of the agreement. The Pearls and Schreiber were among the five stockholders who objected to the settlement's terms. They appeared at the hearing and objected to the settlement based upon arguments similar to the ones that they raised before the district court and to ones that they now raise before this Court.

After consideration of those arguments, the district court entered an order on December 15, 1981 approving the settlement agreement as "fair, reasonable and adequate." The Court stated that the "Ohio formulation of the business judgment doctrine" placed upon the independent directors the responsibility to decide whether derivative suits should be dismissed. The Court concluded, therefore, that the suits would "very likely" be dismissed on summary judgment. The factors noted by the Court in support of the "reasonableness" of the settlement included (1) the fashioning of remedial measures, (2) the appointment of outside directors to RKO's board, (3) the difficulty of proving damages to and recovering damages for the corporation, (4) the complexity and expense of further litigation and (5) the relatively small number of objectors to the settlement.

In this "reasonableness" calculus, the district court referred generally to the pending FCC and IRS proceedings. After the district court determined that the settlement was "fair, reasonable and adequate," the Supreme Court denied certiorari in the case of *RKO General* v. *FCC*, 670 F.2d 215 (D.C. Cir. 1981). RKO thereby exhausted its appellate remedies and forfeited all rights to one of its major television licenses. In May, 1982, the station terminated its operations at an estimated loss of over $100,000,000.00 The district court did not consider the effect of that specific dollar loss in concluding

that the settlement agreement was "fair, reasonable and adequate."

By separate order, the district court also denied Schreiber the right to intervene as a party to this litigation. The Court stated that, as a shareholder, Schreiber had been adequately represented. Furthermore, the district court stressed that Schreiber has the right to appeal, a right which he now exercises.

Although these factual circumstances which give rise to the present appeal are quite complex, our task as a reviewing court is clearly defined. Federal Rule of Civil Procedure 23.1, which governs derivative suits, provides that "[t]he action should not be dismissed or compromised without the approval of the court." This Court will set aside the district court's approval of a settlement agreement only if the discretion afforded that court has been abused. *Masterson* v. *Pergament*, 203 F.2d 315 (6th Cir.), *cert. denied*, 346 U.S. 832 (1953); *Cohen* v. *Young*, 127 F.2d 721 (6th Cir. 1942); *Young* v. *Katz*, 447 F.2d 431 (5th Cir. 1971). The discretion afforded by Rule 23.1 permits the district court to act as a third party to the compromise and a guardian of the corporation's interest. *Masterson*, 203 F.2d at 315. The proponents of the settlement, however, have the burden of persuading the court that their compromise is fair, reasonable and adequate. *Cotton* v. *Hinton*, 559 F.2d 1326 (5th Cir. 1977).

A. Approval of the Settlement

The objectors now principally assert that the district court abused its discretion in approving the settlement. They contend that (1) the court erred in its assessment of the Ohio business judgment doctrine's effect on the success of the pending litigation, (2) erred in its determination that the outside directors acted independently, impartially and in good faith, and (3) erred in its conclusion that the settlement was "fair, reasonable and adequate."

(1) The Ohio Business Judgment Rule

In the context of shareholder derivative suits, the interpretation and application of the business judgment rule is a question of state law. *Burks* v. *Lasker*, 441 U.S. 471 (1979). Because General Tire is incorporated in Ohio, the law of that state clearly applies to this action. Ohio, as a general matter, has adopted the business judgment rule. *Sims* v. *Street Railroad Co.*, 37 Ohio St. 556 (1862).

In *Wadsworth* v. *Davis*, 13 Ohio St. 123 (1862), the Ohio Court first held that the board of directors is empowered to decide whether to bring a suit on behalf of the corporation. Courts may not challenge the directors' decision where that decision is unbiased and made in good faith. *Rice* v. *Wheeling Dollar Savings & Trust Co.*, 71 Ohio L. Abs. 205, 130 N.E.2d 442 (1954); *Roderick* v. *Canton Hog Ranch Co.*, 46 Ohio App. 475, 189 N.E. 669 (1933). A stockholder has no independent right to bring a suit to void a contract unless the directors' refusal to bring the suit is "wrongful, fraudulent and arbitrary." *Cooper* v. *Central Alloy Steel Corp.*, 43 Ohio App. 455, 183 N.E. 439 (1931). The district court concluded from this line of cases that the Ohio formulation of the business judgment doctrine is "crystal clear" and predicted that Ohio courts would apply that general doctrine to the particular circumstances of a shareholder's derivative action.

Although we do not find the impact of the Ohio business judgment rule upon this case to be "crystal clear," we do agree with the district court's assessment of that impact. In *Cooper*, wherein individual directors were named as defendants, the Court rejected a summary dismissal and addressed the merits of the underlying controversy. 183 N.E. at 442. The Court, in ruling for the directors, stated that they had met the "severest" test of showing that the transactions were "fair and free of taint of fraud." *Cooper* declined however to hold that this "severest" test of director disinterestedness is the

"rule" in Ohio. 183 N.E. at 445. In *Roderick*, the Court refused to excuse the shareholder's lack of "demand" on non-party and unbiased directors. But in view of the fact that the plaintiff had only alleged the directors' "supine acquiescence" in waste and mismanagement, and the fact "that they would not be called upon to order the corporation to sue themselves," the Court held that the "demand" would not have been futile. The Second Circuit, in *Galef* v. *Alexander*, 615 F.2d 51, 61 (2nd Cir. 1980), interpreted the Ohio business judgment rule and inferred from this portion of the *Roderick* opinion that Ohio Courts might "consider a summary dismissal of a suit against [the directors in a derivative suit] to be unavailable." Finally in *Rice*, the Court validated a resolution opposing a lawsuit passed by directors who were not named as parties to the lawsuit and who were not involved in any wrongdoing. In approving the resolution, *Rice* relied upon the fact that there was "*no* showing" that the directors' decision was biased. 130 N.E.2d 448. (Emphasis added).

Our analysis of *Rice*, *Roderick* and *Cooper* coincides with the Second Circuit's review of those cases in *Galef*. The *Galef* court found that a liberal application of the Ohio business judgment rule to shareholder derivative actions is "hardly trumpeted" by this line of cases. 615 F.2d at 61. We concur with the Second Circuit that these cases alone do not provide any "clear" guidance on the application of the Ohio business judgment rule to the case at bar. 615 F.2d at 62.

The objectors contend that this Court should look to the federal policy underpinning § 14(a) of the Securities Exchange Act for guidance on the application of the business judgment rule. Their contention is supported by language in *Galef*. In that case, the Second Circuit stated:

> Even if Ohio law had been found generally to permit directors who have been sued to initiate a business judgment summary dismissal of the suit against them, serious questions would persist with respect to the . . .

> directors attempt to cause such a dismissal of the § 14(a) claims.

Galef, 615 F.2d at 62. The *Galef* Court concluded that well-pleaded § 14(a) claims against directors are not the proper subject of summary dismissal. To the extent that the purposes underlying § 14(a) clash with the Ohio business judgment rule, that rule must give way to the overriding federal policy. In *Burks* v. *Lasker*, 441 U.S. at 479, the Supreme Court agreed that state law should be applied to the business judgment issue "unless the state laws permit action prohibited by the [federal statute], or unless 'their application would be inconsistent with the federal policy underlying the cause of action.'"

Were we to find, therefore, that the application of the Ohio business judgment rule to this case would run afoul of the policies of § 14(a), we would be unable to apply that rule, in any form, to this action. Thus we must decide whether the application of the Ohio business judgment rule would be inconsistent with the prohibition in § 14(a). That section provides:

> It shall be unlawful for any person by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 781 of this title.

15 U.S.C. § 78n(a) (1976). The Congressional purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. *J. I. Case Co.* v. *Borak*, 377 U.S. 426 (1964). The provision, more specifically,

was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which . . . [had] frustrated the free exercise of the voting rights of stockholders." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 13, 14.

We take profound note of the reality that this federal policy is often frustrated by the application of a state's business judgment rule. In many instances, derivative actions are the only means of private redress for a § 14(a) violation. Summary dismissal of those cases "would be tantamount to denying a type of enforcement that is essential to the accomplishment of the goals of § 14(a)." *Borak*, 377 U.S. at 432. Indeed § 14(a) would become a nullity if a defendant-director in a derivative action alleging failure to supply adequate information in a proxy solicitation were permitted to dismiss the action on the basis of his own business judgment.

The policies of § 14(a) do not clash with the business judgment rule, however, where a connection between the underlying allegations and the *proxy process* is absent. Where there is no "causal link between" the challenged nondisclosures in the proxy statements and an influenced election, the conflict between a state's business judgment rule and the policies of § 14(a) is diluted. *See Galef*, 615 F.2d at 66; *Gaines* 645 F.2d at 773-76. In the case at bar, the objectors' proxy claims merely restate allegations relating to the underlying improprieties. Those claims are not connected with transactions authorized by the shareholders through the proxy process. The objectors in this case can not demonstrate a causal link between the challenged activity and the proxy process. The purposes of § 14(a), for that reason, do not apply to, and are not thwarted by, this particular derivative suit. We are unable to conclude, on these specific facts, that the existence of proxy statement claims under § 14(a) precludes dismissal of these suits or that Ohio law is preempted by any overriding federal policy.

The inapplicability of federal law and the paucity of

controlling Ohio law on the scope of the business judgment rule, therefore, requires that we search to other states for guidance on how the Ohio courts would apply that rule to the facts before us. § 1701.59 of the Ohio Code explicitly permits the board of directors to delegate to a special committee the power to decide whether litigation is in its best interests. Ohio law allows the directors to act in good faith reliance upon a special litigation committee's recommendations.[5] The corporate law of most states favors the extension of the business judgment rule to encompass decisions formulated by such an "authorized board committee comprised of disinterested directors as to the availability of asserting a cause of action possessed by the nominal corporation against some members of the board of directors for alleged wrongdoing." *Watts* v. *Des Moines Register and Tribune*, 525 F.Supp. 1311, 1325 (S.D. Iowa 1981). *See Burks*, 441 U.S. at 480; *Lewis* v. *Anderson*, 615 F.2d 778, 782-83 (9th Cir.) *cert. denied*, 449 U.S. 869 (1980) (California law); *Abbey* v. *Control Data Corp.*, 603 F.2d 724, 729 (8th Cir.), *cert. denied*, 444 U.S. 1017 (1980) (Delaware law); *Grossman* v. *Johnson*, 89 F.R.D. 656, 662-663 (D. Mass. 1981) (Maryland law); *Abramowitz* v. *Posner*, 513 F. Supp. 120, 125-26 (S.D. N.Y. 1981) (Delaware law). In view of this weight of authority and of § 1701.59, we join the district court's prediction that the Ohio courts would apply to these

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[5] § 1701.59 provides: Authority of directors; bylaws; reliance of director on corporate records

(A) Except where the law, the articles, or the regulations require action to be authorized or taken by shareholders, all of the authority of a corporation shall be exercised by its directors. For their own government the directors may adopt bylaws not inconsistent with the articles or the regulations.

(B) In discharging his duties, a director may, when acting in good faith, rely upon the books and records of the corporation, upon reports made to the corporation by an officer or employee or by any other person selected for the purpose with reasonable care by the corporation, and upon financial statements or written reports prepared by an officer or employee of the corporation in charge of its accounts or certified by a public accountant or firm of public accountants.

facts the business judgment rule, precluding unnecessary judicial interference with the decision of an independent disinterested corporate committee to forego litigation of derivative claims.

Objectors contend that if the business judgment rule extends at all to the actions of a special litigation committee, it must do so in the stringent form articulated in *Zapata Corp.* v. *Maldonado*, 430 A.2d 779 (Del. S. Ct. 1981). That decision seeks to balance the independent judgment of a board committee against unbridled plaintiff stockholder control of a derivative action. In an effort to achieve that balance, *Zapata* inquired into the independence and good faith of the committee and then applied its own business judgment to determine the propriety of summary dismissal. The Court fashioned four criteria for judicial review of an independent litigation committee's conclusion: (1) the procedural propriety of an objector's suit, (2) the committee's corporate power to seek dismissal of the suit, (3) the disinterest, independence and good faith of committee members, the bases for the conclusion of such members and the appropriateness and sufficiency of their investigative techniques and (4) the Court's own independent business judgment. *Zapata*, 430 A.2d at 784-89.

The question before this Court, therefore, is whether the Ohio courts would adopt a more deferential review of a special litigation committee's findings or would question those findings in light of their own independent business judgment. We find much to commend both the conventional deferential view and the more novel *Zapata* view. Because we conclude that the district judge's review of the settlement decision complied with the more severe *Zapata* standard, however, we need not decide in this case which view the Ohio courts would adopt. The objectors clearly complied with Rule 23.1's "demand" requirement and thus the district court found no procedural defect in initiating the derivative suit. The district judge, consistently with the *Zapata* standard, also clearly

reviewed the committee's corporate power to seek dismissal under Ohio's business judgment rule.

(2) The Independence of the Outside Directors

The objectors contend that the district court did not adequately review the independence of the outside directors who decided to abandon the derivative suits. We find to the contrary that the district court did indeed carefully consider the disinterestedness of the outside directors. Generally, assertions of the director's lack of good faith must be supported by facts rather than by invective and conclusory allegations. *Gaines,* 645 F.2d at 765. In circumstances in which the directors are *directly* liable, however, a well-pleaded complaint may suffice to place the burden upon the director to prove independence. *See* e.g. *Abromowitz* v. *Posner,* 672 F.2d 1025 (2d Cir. 1982); *Stein* v. *Bailey,* 531 F. Supp. 390 (S.D. N.Y. 1980). In the instant case, however, the board members are not charged in the derivative actions with direct liability. The mere fact that a director has been named as a party or implicated in the litigation does not, without more, demonstrate bad faith. *Galef,* 615 F.2d at 60 n. 17; *Lewis* v. *Anderson,* 615 F.2d 778, 781-83 (9th Cir. 1979); *Abbey* v. *Control Data Corp.,* 603 F.2d 724, 727 (8th Cir. 1979), *cert. denied,* 444 U.S. 1017 (1980).

The Court properly found that the objector's had not demonstrated that the directors were biased. The Court examined the extensive record "for indications of suspicious relationships between these outside directors and the inside management of General Tire" and "found none." The Special Review Committee, independent counsel and the Bricker & Eckler firm each found that outside directors Walsh, Mansfield, Henkel, Morley, Tullis and Garvin were "independent." The district court concluded generally that these outside directors were "independent."

The objectors challenge specifically the independence of

Henkel, a partner of the law firm retained by General Tire, and Garvin, who helped General Tire investigate its conduct in Chile. The district court reviewed the disinterestedness of Henkel:

> Mr. Henkel provided legal assistance to the Company as outside counsel for Securities-related matters for many years. These relationships in themselves would seem insufficient to establish bias in the outside directors, or control of them by inside management.

The district court properly concluded that Henkel's mere legal association with General Tire does not alone disqualify him from exercising independent business judgment. We cannot fashion a flat rule which allows only those individuals with absolutely *no* contact with the Company to exercise independent business judgment. Such a rule would preclude virtually every outside director from involvement in the business judgment by virtue of having been nominated or selected by the corporation. The district Court did not abuse its discretion in analyzing Henkel's disinterestedness.

The district court was similarly within its discretion when it determined that Garvin was capable of exercising independent business judgment. Garvin served General Tire as an "independent consultant" to investigate its questionable corporate practices in Chile. As a former Citicorp officer with responsibility for Latin American business, Garvin was particularly well qualified for that investigation. Garvin did not participate in General Tire's Chilean affairs, he only participated in the corporation's attempt to scrutinize those affairs after they had occurred. The independence of Garvin is borne out by the Bricker firm's conclusion that he was "absolutely and totally unassociated" with the events compiled in the Special Report or with the events surrounding the 1980 litigation.

Our review of the record indicates that the district judge conducted a careful examination into the independence of

Garvin, Henkel and all of the outside directors. That examination revealed:

> little, if any, evidence to temper their appearance of being upright, responsible leaders in the business and civic communities.

The district judge properly found insufficient evidence of the outside director's fraud or bad faith to warrant the conclusion of the lack of independence. We find that the district judge's analysis of the "disinterest, independence and good faith" of the committee members was consistent with the *Zapata* standard.[6]

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[6] The objectors sought discovery with respect to the issue of the independence of General Tire's directors and claim that the district court improperly denied their discovery rights. While objectors are entitled to "meaningful participation" in the settlement proceedings, *Girsh* v. *Jepson*, 521 F.2d 153, 158 (3rd Cir. 1975) and "leave to be heard," *Cotton* v. *Hinton*, 559 F.2d 1326, 1331 (5th Cir. 1977), they are not automatically entitled to discovery or "to question and debate every provision of the proposed compromise." *Cotton*, 559 F.2d at 1331.

In this case, the Special Review Committee, two independent firms of outside counsel and the plaintiffs all thoroughly examined the issue of the outside directors' independence. The objectors themselves filed lengthy memoranda on the subject and participated in the settlement hearing. Despite this plethora of information submitted to the district court, the objectors requested additional discovery.

In deciding whether the district court erred in denying that discovery, we must inquire.

> Whether or not the District Court had before it sufficient facts intelligently to approve the settlement offer. If it did, then there is no reason to hold an additional hearing on the settlement or give appellants authority to renew discovery.

Detroit v. *Grinnell*, 495 F.2d 448, 463 (2d Cir. 1974). We find that the district court assembled "sufficient facts intelligently to approve the settlement." That Court certainly allowed the objectors "meaningful participation" in the settlement hearing generally and on the question of director disinterest particularly.

In a similar vein, we find no merit in the objectors contention that the district court abused its discretion in denying them access to depositions filed with the Court one day before the hearing. The district judge quite properly granted objectors additional time to file post-hearing papers to incorporate any information revealed by those transcripts.

(3) The Fairness, Reasonableness and Adequacy of the Settlement

Moreover, the Objectors do not really question, nor could they succeed in questioning, the "adequacy of the investigatory procedures" and the "bases for the Committee's conclusion." Aided by its counsel and accountants, an initial Special Review Committee conducted a thorough investigation into the history of General Tire's past practices. The Committee distributed questionnaires, conducted personal interviews, telephoned contacts, examined expense reports and reviewed all billings for sales in excess of $50,000. The Committee's work culminated in a 233 page report which was filed in the United States District Court for the District of Columbia. General Tire used the Committee's findings and recommendations to help them determine whether the continuation of the derivative suits was in its best interests.

In addition, General Tire retained the Bricker firm to assess the independence of board members and the merits of the pending litigation. The firm recommended that the independent board members seek dismissal of the pending suits. Those members acted on the Bricker firm's advice. The process by which that recommendation was constructed and implemented was not only "adequate," it was superior. The compilation of facts which formed the "bases" for the Committee's recommendations clearly satisfied the *Zapata* requirement.

The district court, perhaps most crucially, satisfied the final *Zapata* requirement by exercising its own independent business judgment to determine whether dismissal of the derivative suits was warranted. After reviewing the terms of the proposed settlement, the district judge independently concluded:

> It is the opinion of this Court, based upon the considerations just enunciated, that the proposed settlement is a reasonable one.

The district court was not unmindful of the "obvious" shortcomings of the settlement, but felt that the advantages outweighed the disadvantages.[7] The Court judged that the shareholders, all but five of whom accepted the agreement, "would have faced considerable difficulties had they brought this litigation to trial." The addition of outside directors to the board of RKO General and the small number of objectors to the settlement were also factors which the district court weighed in finding that the settlement was in the best business interests of the corporation. Thus the district court, in keeping with *Zapata*, gave "special consideration to matters of law and public policy in addition to the corporation's best interests." *See Zapata*, 430 A.2d at 788. We conclude, therefore, that even under the more stringent version of the business judgment rule expressed in *Zapata*, the district court did not abuse its discretion in determining that the director's "very likely" had the power to dismiss the derivative suits.

The exercise of that power, of course, precludes success on the merits. The most important of the factors to be considered in reviewing a settlement is the probability of success on the merits. *Newman* v. *Stein*, 464 F.2d 689, 692 (2nd Cir.), *cert. denied*, 409 U.S. 1039 (1972). The likelihood of success, in turn, provides a gauge from which the benefits of the settlement must be measured. *See Cotton* v. *Hinton*, 559 F.2d 1326, 1330 (5th Cir. 1977). The district court, in view of the slight possibility of successful litigation, was well within its discretion when it determined that the settlement was "reasonable, fair and adequate." The arguments against the reasonableness, fairness and adequacy of that settlement before this Court are no different from those raised below. The objectors, in effect, would have this Court reject the independent business judgment arrived at by a Special Com-

[7] Objector Schreiber apparently argues that the district court's approval of the settlement effectively terminated a class action pleaded by plaintiff Milberg. We do not understand this settlement, however, to encompass the denial of any such class action.

mittee of lawyers, accountants and businessmen after a thorough investigation. The objectors would also have this Court reject the additional independent business judgment of the district court after his careful review of the record. Even if we were to agree with the business judgment of the five objectors, we are not prepared to substitute that judgment for the judgment of the district court, the Special Committee and the outside directors. Absent any finding that the district court abused its discretion in concluding that the settlement was "reasonable, fair and adequate," we will not reverse that judgment merely because of a business "disagreement."

(B) Additional Claims Surrounding the Settlement Approval

(1) Pending FCC and IRS proceedings

The objectors also contend that the district judge abused its discretion in approving the terms of the settlement without considering pending FCC and IRS proceedings. The "notice of hearing," they argue, failed to address the potential losses resulting from the FCC and the IRS actions. Notice under Rule 23, however, need only be "reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *See Mullane* v. *Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1956); *Mendoza* v. *United States*, 623 F.2d 1338, 1350-51 (9th Cir. 1980). Rule 23 "accords a wide discretion to the District Court as to the form and content of the notice." *Id.*

The district court's notice was not an abuse of discretion in this case. The notice described the terms of the settlement, the reasons for the independent director's determination to seek dismissal of the suits, the legal effect of the settlement and the rights of the shareholders to voice their objections. The "notice" clearly referred to the potential loss of broad-

cast licenses. Although it did not predict the dollar amount of the loss, the notice did conform to proper disclosure practice. *Kohn* v. *American Metal Climax, Inc.*, 458 F.2d 255, 264 (3rd Cir.), *cert. denied*, 409 U.S. 874 (1972). The district court's approval of the notice, therefore, was within its wide discretion.

Furthermore, the district court quite properly rejected the objectors' argument that a true balancing of the settlement terms must await the outcome of pending FCC and IRS proceedings. The Court placed itself in the position of an independent director of the corporation and determined that any delay in approval of the settlement would be counter to General Tire's business interest. The district court correctly noted that "pending" FCC proceedings could remain "pending" for "many years." The district court, exercising its independent business judgment as "a representative of the interests of the Company," could not

> permit such a sword of Damocles to be suspended above the directors and management of General Tire. To rule otherwise would establish a longterm, destructive impediment to the exercise of their business judgment in the day-to-day operations of the firm.

While the monetary losses surrounding the FCC and IRS proceedings may be unfortunate, they counteract neither the independence of the Committee's business judgment, nor the independence of the district court's additional business judgment. The wide discretion afforded the district court was hardly abused.

We find therefore that the district court did not abuse its discretion in its penetrating review of the propriety of the delegation of the board's authority, the propriety of the application of the Business Judgment Rule, the propriety of the Special Committee's members and techniques and the propriety of the terms of the settlement agreement. Moreover,

the district judge astutely assessed the merits of the settlement agreement in accord with its own business judgment.

(2) Intervention

Objector Schreiber finally argues that the district court erred in denying his petition to intervene. Rule 24(a) of the Federal Rules of Civil Procedure governs a proposed intervention of right:

> Upon timely application anyone shall be permitted to intervene in an action: (1) when a statute of the United States confers an unconditional right to intervene; or (2) when the applicant claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest, unless *the applicant's interest is adequately represented by existing parties.*" (Emphasis supplied.)

A shareholder has no greater rights in a derivative action than does an objector. Any relief obtained belongs to the corporation only; a shareholder has no individual rights to protect through litigation. Hence Schreiber's interests are not only "adequately protected" by the shareholders, they are identical to those of the shareholders. Intervention will be denied where, as in this case, "the applicants' interest is adequately representd by existing parties." *Trbovich* v. *United Mine Workers of America,* 532 F.2d 1074, 1077 (6th Cir.), *cert. denied,* 429 U.S. 834 (1976); *Afro American Patrolmen's League* v. *Duck,* 503 F.2d 294, 298 (6th Cir. 1974). Before the district court, objector Schreiber only questioned the fairness of the settlement. The district court, therefore, did not abuse its discretion in denying Schreiber's petition for intervention.

Upon consideration of the complex issues in this case, we conclude that the district judge's findings and conclusions

were not an abuse of discretion. Accordingly, the orders of the district court approving the settlement and denying intervention are hereby AFFIRMED.

WELLFORD, Circuit Judge, concurring in part and dissenting in part.

I am in agreement with the analysis of Ohio law on the business judgment rule made by Judge Jones, and conclude also that the cases cited do not provide clear guidance, contrary to the district court's characterization of that law as "crystal clear." I further agree that the Ohio application of the business judgment rule, although unclear, does not contradict the policies of § 14(a) of the Securities Exchange Act under the circumstances of this case. I concur also that the district court made an adequate analysis of, and granted sufficient discovery, with respect to the independence of the outside directors in this case, although the prior association of Henkel with General Tire rendered his position doubtful at best. I agree also with Judge Jones' conclusion that denial of objector Schreiber's motion to intervene was not an abuse of discretion.

I part company, however, on the question of the fairness of the settlement in this case. In the majority opinion, it is fully recognized that actions taken by RKO General, for which all the defendants may share some responsibility, and who certainly faced very serious exposure by reason thereof, had cost the company a valuable television license. The decision in *RKO General* v. *F.C.C.* 670 F.2d 215 (D.C. Cir. 1981), cert. denied, 457 U.S. 1119 (1982) had already virtually determined this ultimate estimated loss of $100,000,000,

and "the district court did *not* consider the effect of that specific settlement agreement was 'fair, reasonable and adequate.'"[1]

The consideration of the reasonableness of the settlement did not take fully into account alleged "cover up" activities after 1975 with respect to administrative investigations and the effect of additional IRS actions pending against defendant General Tire and RKO General due to irregularities, and shareholders were not alerted to this additional potential loss, for which defendant directors may have had some responsibility. The alleged benefits to the corporation arising out of the settlement, apart from what was already recommended by the special investigative committee to avoid such future financial disasters, were negligible in my view. $500,000 would be paid by General Tire to the plaintiffs' attorneys; the only benefit was that two members of the RKO Board for three years would be non-officers and non-employees.[2]

Even if settlement were deemed advantageous because plaintiffs "would have faced considerable difficulties had they brought this litigation to trial," *Pearl* v. *The General Tire & Rubber Co.*, MDL No. 265, slip op. at 12 (D. Ohio, Dec. 15, 1981), the miniscule benefits to the corporations and their shareholders do not sufficiently take into account the risks that defendants faced.[3] That plaintiffs' lawyers are satisfied because they were to receive substantial fees without objection from defendants renders the fairness of such settlement even more dubious. *See Jamison* v. *Butcher*, 68 F.R.D. 479 (D. Penn. 1975).

---

[1] In any event, whatever the amount of the actual total loss, it was large and "unprecedented." *RKO, supra*, 670 F.2d at 235.

[2] The adding of two non-officer directors to the Board of Directors of RKO General is deemed to be no real benefit in view of the absolute control of RKO by General Tire.

[3] The trial judge conceded there was "[n]o *monetary recovery* to the corporation . . . contemplated in this settlement." *Pearl*, slip. op. at 11. (Emphasis added).

Particularly in view of then pending very serious additional F.C.C. and I.R.S. proceedings against General Tire, the action of the court in approving a bar of all future shareholders' claims arising out of these matters is an abuse of discretion. Whether or not the settlement terminated the present and any future class action challenges,[4] including the Miberg action it seems clear that the district court intended its order to do just that:

> The complaints in these actions are dismissed on the merits and with prejudice and without costs. The order entered today represents a full and final discharge against all persons whatsoever of any and all claims which were, or could have been, alleged in the complaints, by reason of, in connection with, or which arise out of the matters or transactions set forth or referred to.

Pearl, slip op. at 14.

As suggested in oral argument before this court, at the very least the settlement could have eliminated (permanently or for a period of time) defendant directors' options or prequisites of office, and/or imposed upon them responsibility to pay a portion of plaintiffs' attorney fees.

I would conclude that the district court abused its discretion in approving this settlement as fair and reasonable under the circumstances indicated.

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[4] See footnote 7 of the majority opinion wherein Judge Jones states, without deciding, "[w]e do not understand this *settlement*, however, to encompass the denial of any such class action." (Emphasis added.) *Compare National Super Spuds v. N.Y. Mercantile Exchange*, 660 F.2d 9 (2d Cir. 1981).

Filed
3/7/84

Appendix B1

Nos. 82-3129/3130

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOHN J. PEARL & CURTIS R. PEARL, AND GEORGE BROOKS SCHREIBER,

Objector-Appellants,

v.

THE GENERAL TIRE & RUBBER CO., ET AL,

Appellees.

ORDER

BEFORE: JONES AND WELLFORD, Circuit Judges and HARVEY, District Judge*

Upon re-consideration of the issues presented by this appeal, the Court concludes that rehearing in the above-captioned case is not warranted. The petition for rehearing filed by John J. Pearl and Curtis R. Pearl is therefore denied.

The Court in addition dismisses Objector Schreiber's petition because that petition was not timely filed.

The Court, however, has concluded that some clarification of its understanding of the scope of the Settlement Agreement is warranted. Accordingly, the Court hereby modifies the language of Footnote 7 to provide:

> Objector Schreiber apparently argues that the district court's approval of the Settlement effectively terminated a class action pleaded by plaintiff Milberg. We do not understand this settlement, however, to encompass the denial of any such class action. Nor do we understand the settlement to bar all future shareholders' claims arising out of the very serious additional F.C.C. and I.R.S. proceedings against General Tire.

ENTERED BY ORDER
OF THE COURT

John P. Hehman/lG

Clerk

*The Honorable James Harvey, United States District Judge for the Eastern District of Michigan, sitting by designation.

Filed
3/8/84

B3

Nos. 82-3129/3130

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOHN J. PEARL & CURTIS R. PEARL, AND GEORGE BROOKS SCHREIBER,

Objectors-Appellants,

v.

THE GENERAL TIRE & RUBBER CO., ET AL,

Appellees.

AMENDED ORDER

BEFORE: JONES AND WELLFORD, Circuit Judges and HARVEY, District Judge*

John J. Pearl and Curtis Pearl, and George Brooks Schreiber, objectors-appellants, filed petitions for rehearing and rehearing en banc in the above-styled case. Said petitions were circulated and considered by the full en banc court. No active Judge of this Court requested a polling or favored a rehearing en banc and the matter was, thus, referred to the

original panel. Upon consideration of petitioner's requests, the panel finds the petitions to be without merit and they are hereby denied.

Appellant Schreiber also seeks clarification of the language with respect to the scope of the settlement agreement. The Court has concluded that some clarification by this panel is warranted. Accordingly, the court hereby modifies the language of footnote 7 to provide:

> Objector Schreiber apparently argues that the district court's approval of the settlement effectively terminated a class action pleaded by plaintiff Milberg. We do not understand this settlement, however, to encompass the denial of any such class action. Nor do we understand the settlement to bar all future shareholders' claims arising out of the very serious additional F.C.C. and I.R.S. proceedings against General Tire.

In all other respects the appellant

*The Honorable James Harvey, United States District Judge for the Eastern District of Michigan, sitting by designation.

Schreiber's motion for clarification is denied.

The previous order of March 7, 1984 entered on this matter is vacated.

ENTERED BY ORDER OF
THE COURT

John P. Hehman/lG

CLERK

United States District Court

FOR THE DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

v.

THE GENERAL TIRE & RUBBER COMPANY
MICHAEL GERALD O'NEIL

Defendants.

CIVIL ACTION NO. 76-0799

FINAL JUDGMENT OF PERMANENT INJUNCTION AGAINST THE GENERAL TIRE & RUBBER COMPANY AND MICHAEL GERALD O'NEIL

Plaintiff Securities and Exchange Commission ("Commission") having duly commenced this action by filing its COMPLAINT FOR PERMANENT INJUNCTION AND ANCILLARY RELIEF ("Complaint"), and Defendants The General Tire & Rubber Company ("General Tire") and Michael Gerald O'Neil ("O'Neil"), having appeared and admitted to the jurisdiction of this Court over them and over the subject matter of this action, having waived the making of any findings of fact or conclusions of law,

before the taking of any testimony and without trial, argument, or adjudication of any issue of fact or law herein, without admitting or denying the allegations of the Complaint, having consented to the entry of this FINAL JUDGMENT OF PERMANENT INJUNCTION, and General Tire having entered into certain undertakings contained in the CONSENT AND UNDERTAKING OF THE GENERAL TIRE & RUBBER COMPANY annexed hereto and incorporated herein, without this FINAL JUDGMENT OF PERMANENT INJUNCTION, CONSENT AND UNDERTAKING OF THE GENERAL TIRE & RUBBER COMPANY, or CONSENT OF MICHAEL GERALD O'NEIL constituting any evidence or admission by O'Neil, General Tire, or its officers or directors with respect to any of the allegations of the Complaint:

I

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED that Defendant General Tire, its officers, agents, servants, employees, successors, assigns, affiliates [as defined in 17 CFR 240.12b-2(a)], subsidiaries [as defined in 17 CFR 240.12b-2(s)] and attorneys, and each of them, and those persons in active concert or participation with them, and Defendant O'Neil, his agents, servants, employees, successors, assigns, affiliates and attorneys, and each of them, and those persons in active concert or participation with them, are hereby permanently restrained and enjoined from, directly or indirectly, in connection with the purchase or sale of the securities of General Tire or any other issuer, by the use of any means or instrumentality of transportation or communication in interstate commerce or by the use of the mails, employing any device, scheme or artifice to defraud, making any untrue statements of material fact or omitting to state a material fact necessary in order to make the statements made, in light

of the circumstances under which they were made, not misleading, or engaging in any transaction, act, practice or course of business which operates or would operate as a fraud or deceit upon any person concerning:

(1) the nature and extent of any expenditure of corporate funds by General Tire, its affiliates or subsidiaries for unlawful political contributions to any candidate, political party, organization, or any person on behalf of such candidate or party, or for other similar unlawful purposes;

(2) any agreement, commitment or understanding by General Tire or any of its affiliates or subsidiaries to make, or the making of, any unlawful payment of corporate funds or other value directly or indirectly to, or for the benefit of, any official or employee of any foreign government or any official or employee of any entity owned and/or controlled by any foreign government;

(3) the nature and extent of any false or fictitious entries on the books and records of General Tire or any of its affiliates or subsidiaries with respect to the matters referred to in subparagraphs (1) and (2) above, and the nature and extent of any fund of corporate monies or other assets established or maintained without being fully and properly accounted for on said books and records, or the nature and extent of payments, disbursements or transfers, if any, thereof;

(4) the nature and extent of overbilling of affiliates and subsidiaries of General Tire for supplies or services above those amounts agreed upon pursuant to contract by the affiliates or subsidiaries;

(5) the nature and extent of foreign exchange law violations by General Tire, its affiliates and subsidiaries, and contingent liabilities resulting thereof;

(6) the nature and extent of transfers or disbursements of material amounts of corporate funds by General Tire, its affiliates and subsidiaries to con-

sultants, commission agents, or other such persons effected without records and controls reasonably designed to insure that such transfers or disbursements were actually made for the purpose indicated in the respective corporate books and records or the fact that such records or controls have not been maintained or adopted;

(7) the extent to which any director, officer or employee of General Tire or its affiliates or subsidiaries has caused or participated in the activities described in subparagraphs (1) through (6) above.

II

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire, its officers, agents, servants, employees, attorneys, successors, assigns, affiliates and subsidiaries, and each of them, and those persons in active concert or participation with them, and Defendant O'Neil, his agents, servants, employees, successors, assigns, affiliates, subsidiaries and attorneys, and each of them, and those persons in active concert or participation with them, are hereby permanently restrained and enjoined from filing with Plaintiff Commission an annual or other periodic report of General Tire or of its affiliates or subsidiaries required to be filed with the Commission pursuant to Section 13 of the Securities Exchange Act of 1934 and the rules and regulations thereunder, which is materially false and misleading or otherwise not in compliance with said rules and regulations, concerning the matters referred to in decretal paragraph I above.

III

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire, its officers, agents, servants, employees, attorneys, successors, assigns, affiliates and subsidiaries, and each of them, and those persons in active concert or participation with them, and

Defendant O'Neil, his agents, servants, employees, successors, assigns, affiliates and attorneys, and each of them, and those persons in active concert or participation with them, are hereby permanently restrained and enjoined from, directly or indirectly, filing or causing to be filed with the Commission and/or issuing, disseminating or causing to be issued or disseminated proxy soliciting materials, in connection with any future annual or other meeting of shareholders of General Tire, or any of its affiliates or subsidiaries, which are false or misleading or otherwise do not comply with Section 14(a) of the Exchange Act and the rules and regulations thereunder, concerning the matters referred to in decretal paragraph I above, or from taking any action pursuant to any proxy, consent or authorization obtained by use of the mails or means or instrumentalities of interstate commerce unless each person solicited has been furnished, if required by law, with a written proxy statement containing the information required by Section 14(a) of the Exchange Act and the rules and regulations thereunder concerning the matters referred to in decretal paragraph I above.

IV

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire, its officers, agents, servants, employees, successors, assigns, affiliates, subsidiaries and attorneys, and each of them, and those persons in active concert or participation with them, and Defendant O'Neil, his agents, servants, employees, successors, assigns, affiliates and attorneys, and each of them, and those persons in active concert or participation with them, are hereby permanently restrained and enjoined from, directly or indirectly:

A. Using or aiding and abetting the use of corporate funds of General Tire or any of its affiliates or subsidiaries

for unlawful political contributions, or other similar unlawful purposes.

B. Making or causing to be made any materially false or fictitious entries in the books and records of General Tire, its affiliates or subsidiaries, with respect to the matters referred to in decretal paragraph I above, or establishing, maintaining or causing to be established or maintained any secret or unrecorded fund of corporate monies or other assets, or making or causing to be made any payments or disbursements thereof.

V

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire, its officers, agents, servants, employees, successors, attorneys, assigns, affiliates, and subsidiaries shall maintain accurate books and records and supporting documentation for all transactions entered in the books and records of General Tire, and the Commission shall have continuing access to such documentation as it relates to the matters referred to in decretal paragraph I above, which documents will remain in the possession of General Tire.

VI

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the annexed CONSENT AND UNDERTAKING OF GENERAL TIRE be, and the same hereby is, incorporated herein with the same force and effect as if fully set forth herein.

VII

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire shall fully

comply with its undertakings as set forth in the attached CONSENT AND UNDERTAKING OF GENERAL TIRE.

VIII

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that if the terms of the annexed CONSENT AND UNDERTAKING OF GENERAL TIRE are not complied with and implemented by General Tire to the full satisfaction of the Commission, the Commission may apply to this Court for appropriate relief.

IX

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that Defendant General Tire and its officers, directors, agents and controlling persons shall cooperate fully with the Special Committee of the General Tire Board of Directors and Special Counsel, and render such reports and other assistance as the Special Committee and Special Counsel shall reasonably require.

X

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that this Court shall retain jurisdiction of this matter for all purposes.

_____

United States District Judge

DATED:
Washington, D. C.

APPENDIX B

United States District Court

FOR THE DISTRICT OF COLUMBIA

SECURITIES AND EXCHANGE COMMISSION
Plaintiff,

v.

THE GENERAL TIRE & RUBBER COMPANY
MICHAEL GERALD O'NEIL
Defendants.

CIVIL ACTION NO. 76-0799

CONSENT AND UNDERTAKING OF THE GENERAL TIRE & RUBBER COMPANY

(1) Defendant THE GENERAL TIRE & RUBBER COMPANY ("General Tire") admits the jurisdiction of this Court over the subject matter of this action and further admits to the service upon it of Summons and Plaintiff SECURITIES AND EXCHANGE COMMISSION'S ("Commission") COMPLAINT FOR PERMANENT INJUNCTION AND ANCILLARY RELIEF ("Complaint").

(2) General Tire, without admitting or denying any of the allegations in the Complaint, except as to jurisdiction to which it admits, hereby consents to the entry of the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto.

(3) This CONSENT AND UNDERTAKING of The General Tire & Rubber Company ("Consent and Under-

taking") is executed, and the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto is entered, without trial, argument or adjudication of any issue of fact or law, General Tire having waived the entry of findings of fact and conclusions of law. Moreover, neither this Consent and Undertaking nor the FINAL JUDGMENT OF PERMANENT INJUNCTION annexed hereto will constitute or be deemed an admission with respect to any such issue.

(4) General Tire waives any right it may have to appeal from the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto.

(5) General Tire enters into this Consent and Undertaking voluntarily and no promise or threat of any kind whatsoever has been made by the Commission or any member, officer, agent or representative thereof to induce GENERAL TIRE to enter into this Consent and Undertaking.

(6) General Tire agrees that the FINAL JUDGMENT OF PERMANENT INJUNCTION in the form annexed hereto may be presented by the Commission to the Court for signature and entry without further notice.

(7) General Tire represents and undertakes that:

(a) The Board of Directors of General Tire has established a Special Review Committee ("Committee") consisting of five independent members of the Board, and the Committee has retained a Special Counsel. The Committee and its Special Counsel have been authorized to conduct an extensive investigation into the use of corporate funds for unlawful political contributions, gifts, entertainment or other disbursements for similar improper purposes; the use of corporate funds for improper payments to governmental employees and officials, foreign or domestic; the establishment and maintenance of, and transactions in, any secret or unrecorded funds; the use of agents

and consultants for unlawful or improper purposes or in connection with unlawful or improper conduct; and such other similar matters as may be revealed during the course of the investigation;

(b) The Committee and its Special Counsel established by the Board have been authorized to inquire into, examine and review such other matters, including books and records of the corporation, and its subsidiaries and affiliates, which it may deem essential or necessary in order to complete its investigation; and

(c) The Committee and its Special Counsel shall have the right to employ experts, auditors and such other persons and incur such other reasonable expenses, at the expense of General Tire, as the Committee in its discretion deems appropriate.

(8) The Committee and its Special Counsel shall complete its investigation, examination and review within one hundred and eighty (180) days of the entry of the FINAL JUDGMENT OF PERMANENT INJUNCTION, or within such other time as may be reasonable and acceptable to the Commission.

(9) The Committee shall propose and submit a written report ("Report") concerning its investigation, examination and review to General Tire's Board of Directors within thirty (30) days after the Committee and its Special Counsel completes such investigation. The Report shall contain findings as a result of the investigation and any appropriate recommendations to the Board of Directors of General Tire.

(10) General Tire's Board of Directors, acting only through those members found by the Committee not to be involved in the transactions and activities alleged in the Commission's Complaint, shall independently review the Report and will take such action as it determines necessary and proper to implement the findings and recommendations, if any, of said Report.

(11) The Report shall be filed with the Commission as an exhibit to a Current Report on Form 8-K for the month in which the Report is submitted to the General Tire's Board of Directors.

(12) The Report shall also be filed with the Court, as part of the record of this action.

(13) The Board of Directors, through its Audit Committee, shall review, on a continuing basis, the FINAL JUDGMENT OF PERMANENT INJUNCTION and this Consent and Undertaking with a view toward assuring that General Tire has fully complied with the terms of said Judgment, and Consent and Undertaking.

(14) General Tire further consents and agrees that:

(a) This Court shall retain jurisdiction in this matter for all purposes, including applications to the Court to enforce the consents and undertakings contained herein;

(b) If in view of the Commission this Undertaking has not been fully complied with and implemented by the Corporation to the full satisfaction of the Commission, General Tire consents to the application by the Commission to this Court after reasonable notice, to seek such relief as may be necessary or appropriate; and,

(c) This Consent and Undertaking shall be incorporated by reference in the FINAL JUDGMENT OF PERMANENT INJUNCTION, in the form annexed hereto, to be entered by the Court in this action.

THE GENERAL TIRE & RUBBER COMPANY

By J. H. MILLER
J. H. Miller, Vice President

Dated: May 6, 1976
Akron, Ohio

RECOMMENDED FOR FULL TEXT PUBLICATION
See, Sixth Circuit Rule 24

No. 82-3691

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

DR. MALIK M. HASAN AND SEEME HASAN,
Plaintiffs-Appellants,
v.
CLEVETRUST REALTY INVESTORS, et al.,
Defendants-Appellees.

ON APPEAL from the United States District Court for the Northern District of Ohio.

Decided and Filed March 2, 1984

Before: MERRITT and JONES, Circuit Judges; and HOLSCHUH, District Judge.*

Jones, Circuit Judge. This shareholder derivative action is presently before the Court upon the appeal of stockholders, Dr. Malik M. Hasan and Seeme Hasan (Hasan), from an order of the district court granting appellees' motion for summary judgment. Appellants contend that summary judgment in favor of CleveTrust, eight trustees, an advising firm and the Merchant's Fund (CleveTrust) was improperly based

* The Honorable John D. Holschuh, United States District Court for the Southern District of Ohio, sitting by designation.

upon the recommendation of a Special Litigation Committee, the independence, good faith and thoroughness of which presented genuine issues of material fact. Hasan also argues that the district court erred as a matter of law in its particular application of the business judgment rule to the facts of this case. Upon consideration of the complex issues presented by this appeal, we conclude that the district court erred in granting summary judgment because of the existence of genuine issues of material fact which preclude summary judgment as a matter of law.

CleveTrust is a Massachusetts Real Estate Investment Trust with its principal place of business in Ohio. On a national level, CleveTrust's stock prices declined to an amount less than the appraised value of their investment properties. The corporation thus became attractive to companies with an eye toward take over ventures. Two such companies, Tulip and Champion, each acquired 22.4% of CleveTrust's outstanding stock and expressed an interest in purchasing a controlling block of shares. In the event of a takeover, appellee Trustees and Advisers would forfeit their positions. They arranged therefore to repurchase with corporate funds at a price exceeding the fair market value the stock which Tulip and Champion had previously acquired. The Trustees and Advisers also arranged to sell 30% of the CleveTrust's outstanding shares at two-thirds their appraised value to appellee, Merchant Navy Officers Pension Fund Trustee, Ltd., (Merchant Fund). In return for the stock, the Merchant Fund agreed to support CleveTrust's current management, to refrain from selling any stock for a five year period and to give the Trustees and Advisers the first option to repurchase the entire block of CleveTrust stock. The revenue acquired from this sale was used to pre-pay CleveTrust's prior debts, two years before they matured.

As a holder of a significant amount of CleveTrust stock, Hasan brought a derivative action in district court alleging that, through these stock transactions, the Trustees, Advisers

and Merchant Fund caused direct and intentional harm to CleveTrust by wasting corporate assets in order to protect their own lucrative positions. The trustees thereafter appointed a special committee of non-defendant, board members to investigate the challenged transactions and to determine whether the derivative suit would be in the corporation's best interests. Hasan, however, named all but one member of the board of trustees in his suit. The special committee therefore consisted only of Peter Galvin, who was appointed to the board just after the disputed transactions had been completed.

Galvin retained counsel and, based upon interviews with named defendants and others, prepared a 122 page report. The report revealed that Galvin, a real estate broker, owned 25% of a firm that received substantial leasing fees from a company managed by James Carney, the Chairman of the CleveTrust Board. The report also stated that Galvin held a 2% interest in an investment partnership with another named defendant. Galvin concluded however that his own business associations with these named defendants did not compromise the disinterestedness of his investigation and recommendation. Galvin's report rejected each of Hasan's allegations, found that the stock transactions benefitted CleveTrust and concluded that the derivative action was not in the corporation's best interests.

Based upon Galvin's report, the named defendants moved for summary judgment and opposed discovery on the merits. Although the district court allowed discovery on the good faith, independence and thoroughness of Galvin's Committee, Hasan did not participate in such a discovery. Instead, Hasan submitted a sworn affidavit, challenging the substantive charges, and contended that Galvin's report and the circumstances surrounding its creation themselves demonstrated the committee's bias.

The district court, however, granted the defendants' motion for summary judgment and dismissed the complaint with

prejudice. The court considered summary judgment proper because the facts relevant to the case were "not in dispute." The court also concluded that the applicable Massachusetts version of the business judgment rule would grant a special committee "a presumption of good faith, subject to concrete evidence to the contrary." Because Hasan failed through discovery to introduce any affirmative evidence of the committee's bias, the district court reasoned, the presumption of good faith was not rebutted and the committee's report was controlling. The district court determined that the defendants had the power to dismiss this derivative suit against themselves and therefore concluded that summary judgment was appropriate as a matter of law.

In reviewing the district court's summary judgment order, we must first determine whether Federal Rule of Civil Procedure 56(c) applies in the special context of a derivative action. The shareholder derivative action emanates historically from equity jurisdiction. *Hawes* v. *Oakland*, 104 U.S. 450 (1881). Rule 56(c) applies equally to actions at law and actions in equity. The Advisory Notes to that rule state explicitly that the summary judgment standard "is applicable to all actions." As is true generally under Rule 56 (c), therefore, summary judgment must be denied in a proceeding for equitable relief either where genuine issues of material fact exist, *S.E.C.* v. *Koracorp Industries, Inc.*, 575 F.2d 692 (9th Cir.), *cert. denied*, 439 U.S. 953 (1978); *Hess* v. *Schlesinger*, 486 F.2d 1311, (D. C. Cir. 1973), or where judgment is inappropriate as a matter of law. *Booth* v. *Barber Transportation Corp.*, 256 F.2d 927 (8th Cir. 1958). We are thus guided in our review of the district court's summary judgment order in this equitable, derivative action by the normal Rule 56(c) standard. *See Gaines* v. *Haughton*, 645 F.2d 761, 769 (9th Cir.), *cert. denied*, 102 S. Ct. 1006 (1982). We must therefore view the evidence in the light most favorable to the non-moving party to determine whether a genuine issue of material fact existed as to the disinterestedness of the special

litigation committee. *See Adickes* v. *S. H. Kress & Co.*, 398 U.S. 144 (1970); *Malis* v. *Hills*, 588 F.2d 545 (6th Cir. 1978).

The district court found no such genuine issue of material fact. That finding was based upon the legal conclusion that a presumption of good faith attaches to the report and recommendation of a special litigation committee. If that presumption is not rebutted by affirmative evidence, the district court reasoned, then the special litigation committee's recommendation to dismiss the derivative suit must be followed. The initial question before us on appeal therefore is whether the district court erred "as a matter of law" in granting to Galvin's special litigation committee a presumption of good faith.

The basic authority of directors to terminate shareholder derivative litigation is governed by applicable state law unless that law is inconsistent with the federal policies on which the litigaton is based. *Burks* v. *Lasker*, 411 U.S. 471 (1979). Because CleveTrust is a Massachusetts corporation, the law of that state governs this action. The Massachusetts courts have not addressed the precise issue before this Court. We must predict whether those courts would approve the dismissal of a derivative action upon the recommendtion of a special litigation committee, which committee enjoys a presumption of good faith. In so predicting, we must consider the decisions of those states which have analyzed this issue in order to determine which line of analysis Massachusetts, in light of its general approach to derivative suits, is likely to follow.

The corporate law in most states is fairly uniform in sanctioning the general power of a special litigation committee to terminate a stockholder suit. *See Burks*, 411 U.S. at 480; *Lewis* v. *Anderson*, 615 F.2d 778, 782-83 (9th Cir.) *cert. denied*, 449 U.S. 869 (1980) (applying California law); *Abbey* v. *Control Data Corp.*, 603 F.2d 724, 729 (8th Cir.), *cert. denied*, 444 U.S. 1017 (1980) (applying Delaware law); *Grossman* v. *Johnson*, 89 F.R.D. 656, 662-63 (D. Mass. 1981)

(applying Maryland law); *Auerbach* v. *Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994 (1979).

The law in these jurisdictions is split, however, on the question of the scope of appropriate judicial inquiry into the findings of a special litigation committee. In *Zapata Corp.* v. *Maldonado*, 430 A.2d 779 (Del. S. Ct. 1981), the court analyzed under Delaware law the role of the judiciary in reviewing the actions of a special litigation committee authorized to terminate a derivative action. That court was not content to rely upon the business judgment rule to ensure that a special corporate committee acted independently and in good faith in reaching its decisions to forego litigation. Rather, the Delaware Supreme Court established a two-pronged test:

> First, the court should inquire into the independence and good faith of the committee and the bases supporting its conclusion. . . . The Corporation should have the burden of proving independence, good faith and a reasonable investigation, rather than presuming independence, good faith and reasonableness.

430 A.2d at 788. Once the reviewing court is satisfied that the committee has met its burden of proving good faith and reasonableness, the court proceeds to the second prong. That prong requires the court to "determine, applying its own business judgment, whether the motion should be granted." 430 A.2d at 788-89. *See also Abromowitz* v. *Posner*, 672 F.2d 1025 (2nd Cir. 1982); *Joy* v. *North*, 692 F.2d 880 (2nd Cir. 1982) (applying Connecticut law). If we applied to the case before us the *Zapata* approach, therefore, we would assign to CleveTrust the initial burden of establishing its good faith and independence in seeking termination *and then* subject its judgment to objective scrutiny.

But the Delaware approach is hardly the only guideline by which we may predict how the Massachusetts Courts would apply to this case the business judgment rule. Many

states have adopted an approach more deferential to the recommendation of a special litigation committee than that of Delaware. Perhaps most typically, in *Auerbach* v. *Bennett*, 47 N.Y. 2d 619, 393 N.E.2d 994 (1979), the New York Court of Appeals held that the business judgment rule shielded from judicial scrutiny the decision of a special litigation committee to terminate a shareholder derivative action. That decision varies significantly from the Delaware approach in its rejection of judicial authority to apply its own business judgment to the committee's *substantive* recommendations. "To permit judicial probing of such issues," the *Auerbach* court reasoned, "would be to emasculate the business judgment doctrine . . ." 393 N.E.2d at 1002. The court concluded that the committee's "substantive evaluation of the problems posed and its judgment in their resolution are beyond our reach." *Id.* Were we to apply the *Auerbach* standard to the case before us, therefore, we would be precluded from evaluating Galvin's *substantive* recommendations.

Even the *Auerbach* approach, however, empowers this Court to consider the procedural mechanisms of the committee. The *Auerbach* Court, in fashioning its deferential view, was careful to state that

> The business judgment rule does not foreclose inquiry by the courts into the disinterested independence of those members of the board chosen by it to make the corporate decision on its behalf. . . . Indeed the rule shields the deliberations and conclusions of the chosen representatives of the board *only if they possess a disinterested independence and do not stand in a dual relation which prevents an unprejudicial exercise of judgment.*

(emphasis added), 393 N.E.2d at 1001. The court then proceeded to examine carefully the complexion and the procedures of the special litigation committee. Finding that "[n]one of the three [committee members] had had any

prior affiliation with the corporation" and that "the procedures and methodologies chosen and pursued by the special litigation committee" were superior, the *Auerbach* Court concluded that nothing on the record raised a "triable issue of fact." 393 N.E.2d at 1001-003. Under both *Auerbach* (New York law) and *Zapata* (Delaware law), then, a reviewing court must scrutinize the record to determine whether a genuine issue of material fact exists as to the committee's independence, good faith and procedural fairness. The question therefore is not whether this Court has authority to review the good faith of a special litigation committee; it does. The question before us, rather, is by what standard this Court must review the committee's possible biases.

The district court concluded that a reviewing court must accord the committee a presumption of good faith. We disagree. Neither the *Auerbach* approach nor the *Zapata* approach allows a reviewing court to extend to the members of a special litigation committee the presumption of good faith and disinterestedness. As the *Auerbach* court recognized, the policies of the business judgment rule do not protect from judicial scrutiny the complexion and procedures of a special litigation committee. The "business judgment doctrine," that court reasoned:

> Is grounded in the prudent recognition that courts are ill equipped and infrequently called on to evaluate what are and must be essentially business judgments.

393 N.E.2d at 1000. The courts however are particularly well-equipped to evaluate the fairness of a committee's make-up and procedures. In *Auerbach*, the court concluded:

> As to the methodologies and procedures best suited to the conduct of an investigation of facts and the determination of legal liability, the courts are well equipped by long and continuing experience and practice to make determinations. In fact they are better qualified in this regard than are corporate directors in general.

393 N.E.2d at 1003. Thus although the policies of the business judgment rule may accord to the substantive business conclusions of a special litigation committee a presumption of soundness, those policies do not accord to the committee's members a presumption of good faith.

The delegation of corporate power to a special committee, the members of which are hand-picked by defendant-directors, in fact, carries with it inherent structural biases. In their seminal article on the status of shareholder derivative actions, Coffee and Schwartz found in the members of a special litigation committee a strong potential for bias:

> A derivative action invokes a response of group loyalty, so that even a 'maverick' director may feel compelled to close ranks and protect his fellows from the attack of the 'strike suiter.' As a result, an outside director independent enough to oppose a chief executive officer with respect to a proposed transaction he thinks is unfair or unwise may still be unable to tell the same officer that he thinks the suit against him has sufficient merit to proceed . . . a refusal to protect one's peers once events have transpired is seen as disloyal treachery.

Coffee & Schwartz, *The Survival of The Derivative Suit: An Evaluation and a Proposal for Legislative Reform*, 81 Columbia L. Rev. 261 283 (1981).

The problems of peer presure and group loyalty exist *a fortiori* where the members of a special litigation committee are not antagonistic, minority directors, but are carefully selected by the majority directors for their advice. Far from supporting a presumption of good faith, the pressures placed upon such a committee may be so great as to justify a presumption against independence. *See* Dent, *The Power of Directors to Terminate Shareholder Litigations: The Death of The Derivative Suit*, 75 Northwestern L. Rev. 96 (1981). In the case before us, however, we need not determine the propriety of a conclusive presumption against good faith. We

do conclude, though, that the policies of the business judgment rule do not create a presumption in favor of the good faith of a special committee and that the realities of corporate life militate against any such presumption.

We must now predict whether the Massachusetts Courts would support the policies which dictate, and recognize the realities which militate, against a presumption of good faith. The district court found that Massachusetts would prefer to resolve the shareholders' allegations in the "boardroom rather than in the courtroom." Our review of Massachusetts corporate law, however, leads us to predict that the Massachusetts courts would find that the district court erred in presuming Galvin's good faith. In cases in which the directors of a corporation are charged with self-dealing, the Massachusetts courts have not applied the business judgment rule. *American Discount Corp.* v. *Kaitz*, 348 Mass. 706, 206 N.E.2d 156 (1965). Those courts will "vigorously scrutinize the situation" where a director's duty of loyalty to the corporation is in conflict with his or her self-interest. *See, e.g., Production Machine Co.* v. *Howe*, 327 Mass. 372, 99 N.E.2d 32 (1951). The Massachusetts Courts have oft-expressed their unwillingness to allow the business judgment rule to shield the fiduciary transgressions of corporate directors.

The Massachusetts courts furthermore have expressed their skepticism about the ability of the members of a special committee to engage in an independent inquiry about the possible misconduct of their peers. In *Pupecki* v. *James Madison Corp.*, 376 Mass.2d 212, 382 N.E.2d 1030 (1978), the Supreme Judicial Court of Massachusetts held that summary judgment was inappropriate in an action brought by a minority shareholder against the corporation alleging the unlawful sale of assets for inadequate consideration. The court, in concluding that any demand would have been "futile," reasoned that those directors entrusted to decide whether to pursue litigation would be influenced heavily by their corporate counterparts:

> We think that it can be inferred from Fisher's control of the outstanding voting stock that the directors would have acted in a manner favorable to his interests.

382 N.E.2d at 1034. Such an inference hardly coincides with the district court's presumption of Galvin's good faith.

The Massachusetts courts moreover have had occasion to doubt the disinterestedness of a corporate decision made under the auspices of a majority of directors. In *In Re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir. 1973), the First Circuit declared that "[t]he presumption supplied by 15 U.S.C. § 80a-2(a)(9) that '[a] natural person shall be presumed not to be a controlled person'" did not apply to "non-affiliated" directors who decided that litigation was not in the corporation's best interests. 479 F.2d at 265. Any presumption of such "non-affiliated" directors' disinterestedness, the court suggested, would be error. *Id.* The court further opined that

> If a director goes along with a colleague in an act on its face advantageous only to that colleague and not to the corporation, this in itself is a circumstance, or particularity, supporting the claim that he is under that colleague's control.

479 F.2d at 265. In *Kauffman*, then, the court infers from the very fact of a nonaffiliated director's decision to forego litigation in support of a "colleague" the likelihood of bias.

In *Untermeyer* v. *Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978), the First Circuit relied upon *Kauffman* for the proposition that a "defendant charged with self-benefiting misconduct, and who [sic] is affirmatively shown to be able to prevent the trust or corporation from suing him," should not be able to require the shareholder to prove that his influence was not a factor. 500 F.2d at 24. The First Circuit and the Massachusetts Courts, therefore, have articulated a firm willingness to allow judicial scrutiny of corpo-

rate abuses and to place upon corporate decision-makers the burden of proving their disinterestedness. Having analyzed the so-called polar approaches embodied in *Zapata* and *Auerbach*, the policies of the business judgment rule, the realities of corporate collegiality and the predilections of the Massachusetts Courts, we conclude that the district court erred in applying to Galvin a presumption of good faith.

Absent any such presumption, we must determine whether the corporate defendants in this case have demonstrated the good faith and procedural adequacy of Galvin's investigation. We depart neither from the *Auerbach* nor the *Zapata* approach when we scrutinize the "proof submitted by the defendants" for evidence of disinterestedness. *See Auerbach*, 393 N.E.2d at 1001; *Zapata*, 430 A.2d at 788. While those cases diverge on the issue of the judicial deference appropriate to the substantive business judgments of a special committee, they are convergent in their approach to the issues of good faith and thoroughness. In *Zapata*, of course, the court required the corporation to demonstrate the good faith and thoroughness of the special litigation committee. Even in *Auerbach*, however, the court examined carefully the proof submitted by the *defendants* to determine whether the members of a special litigation committee possessed "a disinterested independence" or stood "in a dual relation which prevents an unprejudicial exercise of judgment." 393 N.E.2d at 1001. The court further stated that the corporate defendants themselves would

> be expected to show that the areas and subjects to be examined are reasonably complete and that there has been a good faith pursuit inquiry into such areas and subjects.

393 N.E.2d at 1003.

In the case before us, the corporate defendants have failed to demonstrate that the areas and subjects examined are reasonably complete and that there has been a good faith

inquiry into those areas and subjects. Although the plaintiffs declined to pursue discovery on these issues, Galvin's report itself raises serious questions about the integrity of his committee's findings. That report traces the history of his business relationship with defendant James M. Carney, the Chairman of the CleveTrust Board. In 1968, Galvin possessed a 1/7 interest in "Cragin, Lang," a leasing and management firm. Galvin's firm entered into a services agreement with Investment Plaza Company, of which Carney was a partner. By 1977, Galvin had become President of "Cragin, Lang" and Carney had become managing partner of Investment Plaza. The close business relationship between Carney and Galvin continued after Galvin left "Cragin, Lang." When, in 1979, Galvin became a founding principal and 25% owner of "Adler Galvin Rogers, Inc.," he brought with him Carney's account. At the same time, leasing contracts for properties included within Carney's investment company were transferred from "Cragin, Lang" to "Adler Galvin Rogers."

Galvin, as a founding principal and 25% owner of a leasing and management company, also has a keen interest in attracting real estate developers. Defendant Carney is an active real estate developer in the Cleveland area. Furthermore, Galvin and defendant-trustee Alfred M. Rankin are partners in Bar Associates, a firm which owns a large apartment building in downtown Cleveland. Galvin owns a 2% interest in the building and Rankin owns a 10% interest.

The special litigation committee's report, therefore, by itself, demonstrates several significant business relationships between Galvin and the defendants to this derivative suit. The case before us therefore is clearly distinguishable from *Auerbach*. In *Auerbach*, the court "examined" the defendants' proof and found that none of the three "disinterested directors" who comprised the special litigation committee had "any prior affiliation with the corporation." 393 N.E.2d at 997, 1001. The Court further concluded that the defendants "followed prudent practice" in excluding from the decision-

making process those individuals who had "personal interests which may conflict with the interests of the corporation." 393 N.E.2d at 1001. CleveTrust, by contrast, did not follow "prudent practice" when it selected Peter Galvin as the only member of its special litigation committee. Galvin's "personal interests" and "prior affiliation with the corporation" preclude any affirmative demonstration of disinterest. We find therefore that the corporation has not met its burden of demonstrating the good faith and disinterestedness of Galvin's "committee."

We also find that the corporation failed to demonstrate the procedural adequacy of Galvin's investigation. Galvin failed to interview representatives from Tulip and Champion, the firms which acquired 22.4% of CleveTrust stock in one of the challenged transactions. Tulip and Champion could have provided crucial evidence of the purpose of that challenged transaction and the value of CleveTrust's transferred assets. The committee's report indicates that the transaction with Tulip and Champion "avoids the anticipated proxy fight." (Exhibit 20). Thus the report itself alludes to the trustee's potential loss of control of the corporation. Testimony from Tulip and Champion would provide further concrete evidence of CleveTrust's possible self-interested motivation for the transaction.

Galvin's investigation stands in direct contrast to the special litigation committee's investigation in *Auerbach*. The *Auerbach* Court found that the committee promptly engaged eminent special counsel for guidance, examined the prior work of a special audit committee, interviewed representatives of Wilmer, Cutler & Pickering, and reviewed testimony before the SEC. Perhaps most important, the Court found that the committee conducted personal interviews with individuals who had "participated in any way in the questioned payments." 393 N.E.2d at 1003. Unlike the committee's efforts in *Auerbach*, therefore, Galvin's investigation lacked the

thoroughness which is necessary for a truly objective and meaningful recommendation.

Under the particular facts of this case, we are convinced that the Massachusetts courts would question seriously the good faith and thoroughness of Galvin's recommendation to forego litigation. Galvin's report itself reveals factual issues of disinterestedness and thoroughness which preclude summary judgment. After careful consideration of the law and policies in this field, we also predict with some degree of certainty that the Massachusetts courts would require CleveTrust to demonstrate Galvin's good faith and thoroughness. Saddled with that burden, the corporation can not show Galvin's good faith and thoroughness. The corporation's inability to meet its burden precludes summary judgment as a matter of law. Even if the Massachusetts courts followed the deferential *Auerbach* approach, they would be compelled in this case to conclude that the corporation has not met its burden of demonstrating the disinterestedness and procedural adequacy of Galvin's investigation. Because Galvin's recommendation is based upon his procedurally infirm investigation, that recommendation can not justify the corporation's decision to forego this derivative suit. We hold therefore that the Massachusetts courts, mindful of *Auerbach*, *Zapata*, the proper scope of the business judgment rule and the potential for corporate abuse of that rule, would vacate the district court's summary judgment order and remand for a trial on the merits of Hasan's substantive allegations.

Accordingly, we hereby VACATE the judgment of the district court and REMAND for a trial on the merits.